

Content

| | | |
|---|------------|---|
| A | Chapter 1 | Culture and configuration (A) |
| A | Chapter 2 | Ethical decision making (A) |
| B | Chapter 3 | All about stakeholders part 1 (B) |
| B | Chapter 4 | All about stakeholders part 2 (B) |
| B | Chapter 5 | The integrated report framework (B) |
| B | Chapter 6 | Corporate governance from the inside out (B) |
| B | Chapter 7 | Diversifying the board – a step towards better governance (B) |
| B | Chapter 8 | Independence as a concept in corporate governance (B) |
| B | Chapter 9 | Public sector governance (B) |
| C | Chapter 10 | The Strategic planning process part 1 (C) |
| C | Chapter 11 | The Strategic planning process part 2 (C) |
| D | Chapter 12 | COSO's enterprise risk management (D) |
| D | Chapter 13 | Strategic and operational risks (D) |
| E | Chapter 14 | Cyber security and the strategic business leader |
| E | Chapter 15 | Getting connected to the Internet of Things |
| E | Chapter 16 | Applying big data and data analytics in Strategic Business Leader (E) |
| E | Chapter 17 | E-commerce (E) |
| F | Chapter 18 | Internal audit (F) |
| F | Chapter 19 | Risk and environmental auditing (F) |
| G | Chapter 20 | Performance appraisal (G) |
| H | Chapter 21 | Blockchain: a revolution in the making |
| H | Chapter 22 | Cryptocurrencies and initial coin offerings (ICOs) |
| H | Chapter 23 | Performance indicators (H) |

Note: The section number (e.g. A) refers to Strategic Business Leader syllabus published by ACCA

Introduction

There are different study materials and modes for you to prepare for ACCA professional exams.

You can prepare the exam through self-study mode by reading textbooks and practicing revision tests from Approved Content Providers

Or you can go directly to the classes offered by ACCA Approved Learning Partners and stick into their notes.

However, no matter you are choosing which modes of study or which textbook, you need to know the technical articles published by ACCA for each paper is one of the best materials to prepare for your exams that you cannot miss.

In general, the articles are published by ACCA exam team and the contents are updated on a regular basis.

They highlight the core concepts or important areas that a lot of students cannot do well in the past exams.

The most important part is technical articles are generally the guidance to which question to be seen in upcoming exam.

Here are June 2018 examiners comments on ACCA Paper P7 (Advanced Audit & Assurance):

Question Five

This was a reporting question and was in two sections. It was noted that this question was favoured by candidates who had obviously read the recently updated relevant article on the student website.

The second requirement was to critically appraise an extract from an auditor's report, which had been incorrectly prepared and needed amendment. As noted above it was clear that the candidates who selected this question had evidently read the relevant article and were able to identify that the sections were in the wrong order, contained inappropriate wording and that the key audit matters and emphasis of matters paragraphs had been incorrectly used. Good candidates were able to explain when an issue should be included as a key audit matter or if the issue would result in a qualification and hence needed to be part of the basis of opinion paragraph. Other candidates correctly commented that it would be inappropriate to include an emphasis of matter paragraph but that the report should include a section headed material uncertainty related to going concern.

Since it help thousands of students to prepare exam, I organized the articles published by ACCA and summarized them according to their topics and syllabus with relevant questions as Supplementary Notes for those who are interested to focus on the key or challenging areas.

Remember these articles are helping you to enhance your knowledge on particular subjects, and not a substitute of approved textbook.

Chapter 1 Culture and configuration

Executive Summary

This article focuses on preparing and evaluating a cultural web of an organisation, and the importance of organisational structure and configuration.

Knowledge brought forward from the Accounting in Business (AB) exam

In the ACCA Qualification, organisational culture and structure first arise in the Accountant in Business (AB) exam. Organisational culture was described by Handy as ‘the way we do things round here’. Most of us are very sensitive to organisational culture and tread warily when joining a new school, college or employer: we want to see ‘how they do things round there’.

With regard to organisational culture, the work of three academics is mentioned:

(1) Handy’s four cultural stereotypes. These are:

- **Power culture.** Here, power is concentrated in the hands of one person, ‘the boss’. This culture is often found in small, family businesses, particularly where the name of the business is the same as the name of the boss. Fast – but perhaps arbitrary – decisions can be made. As businesses grow, it becomes more difficult for one person to wield absolute power simply because of the demands on their time and ability. However, it is sometimes seen in large organisations, but then it is usually taken as a danger sign, and many of the corporate governance rules are there specifically to spread power and reduce risks. For example, splitting the roles of chief executive and chairman, holding regular board meetings to encourage collective responsibility, and balancing executive and non-executive directors.
- **Role culture.** This is characterised by a traditional organisational structure in which jobs are arranged by function and seniority, and each employee has a distinct role and job specification. This culture can be efficient in a stable environment in which employees are expected to do the same tasks year-in year-out, but can lead to inflexibility and can slow down response to change as employees defend their roles and rewards.
- **Task culture.** Here, the emphasis is on getting the job done. Flexibility is encouraged and it is more important to serve customers and clients well than to defend one’s role. This culture is much more responsive to environmental and competitive developments.
- **Person culture.** In the person culture the employee is following a personal ambition in the context of the organisation, and interacts with the organisation as little as possible. In this culture the individual is the central point. The organisation is seen as serving the individuals within it. Barristers’ chambers, architects’ partnerships and small consultancy firms often have this person orientation.

The organisation structure is as minimal as possible; the individuals are clustered together, a small galaxy of individual stars.

(2) Schein's determinants of organisational culture. These are:

- **Artifacts.** These are the influences on culture that can be seen. For example, how employees dress, the layout of the office, the way in which people behave.
- **Espoused values.** These are the strategies, goals and objectives of the organisation. For example, an emphasis on low cost or an emphasis on excellent service.
- **Basic assumptions and values.** These are the taken-for granted beliefs. They can be called a 'paradigm', which is a set of assumptions held in common.

(3) Hofstede's international perspectives on culture. Hofstede recognised that people in different countries often have different outlooks and that these will influence organisational culture. The influences are:

- **Power distance.** Cultures that favour low power distance expect power relations to be relatively consultative or democratic. In high power distance countries, the less powerful accept power relations that are more autocratic.
- **Individualism v collectivism.** Individualistic societies place stress on personal achievements. In collectivist societies, individuals act predominantly as members of a group or team.
- **Uncertainty avoidance.** People in cultures with high uncertainty avoidance tend to be more cautious and proceed by careful planning. Low uncertainty avoidance cultures feel relatively comfortable making unstructured situations and dealing with changing and novel environments.
- **Long-term orientation v short-term orientation.** Long-term oriented cultures attach importance to the future and place emphasis on persistence, flexibility and a willingness to change. Short-term oriented cultures emphasise tradition and meeting social expectations.
- **Masculinity v femininity.** Masculine cultures include competitiveness and assertiveness; feminine cultures place greater emphasis on relationships and consensus.

With regard to organisational structure and configuration, the AB *Study Guide* mentions:

Entrepreneurial, functional, departmental, divisional and matrix structures

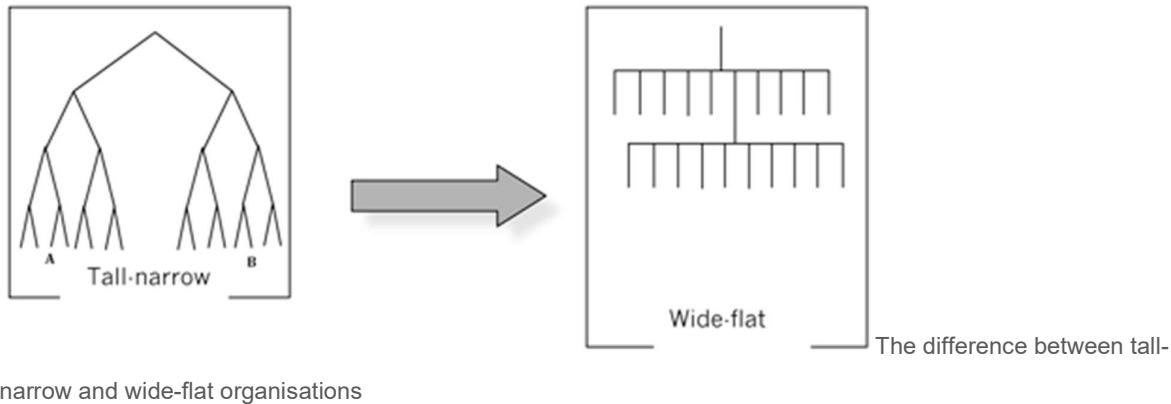
Got it Pass eLearning Co**Supplementary Notes**

- An entrepreneurial structure is one in which the owner (the entrepreneur) dominates. An entrepreneurial structure tends to be found in new businesses, where the entrepreneur is still a hands-on manager. A power culture and an entrepreneurial structure will normally go hand-in-hand.
- A functional (and departmental) structure is a conventional structure with different departments for accounting, sales and marketing, research and development, and so on. This structure can be efficient and can lead to economies of scale, but as departments increase in size and power, they can begin to look after their own interests more than the organisation's. Then a functional organisation has taken on the characteristics of a role culture: intense interest in role rather than getting the job done.
- As businesses grow, there is often a degree of diversification as new products and new markets are developed. It then often makes sense to set up separate divisions for each market and product group as this allows specialisation. So, the European Division will know about pricing, competitors, customer preferences in Europe, and the North American division will develop expertise for that market.
- A matrix structure is very common in project-led organisations as it allows multi-skilled teams to be set up for each project. However, it will mean that an employee is responsible to two superiors, and this was anathema to classical management theory. For example, the person shown below is responsible to the Project B manager and to the quality control manager. It is easy to imagine a situation where the project manager puts pressure on the employee to cut out some tests because the project is slipping and, at the same time, the quality control manager would put pressure on the employee to carry out full testing. The wrong way for the employee to choose what to do is to comply with the wishes of the manager who shouts louder; anyhow, it is unfair to expect the most junior member of the trio to make the decision. However, the matrix structure could empower the employee to point out to the two managers that there is a conflict and that they, as managers and as more experienced employees, should get together to resolve the problem.

| | Engineering | Procurement | Quality control | Design |
|-----------|-------------|-------------|-----------------|--------|
| Project A | | | | |
| Project B | | | | |
| Project C | | | | |

A matrix structure

1. Tall and flat organisations



Tall-narrow organisations are characterised by having many management layers, with each manager looking after only a few subordinates. Wide-flat configurations have relatively few layers, but each manager has many subordinates. In the 1990s and 2000s, many organisations made a determined effort to move from tall-narrow to wide-flat. This process is known as 'delayering' or 'flattening' the organisation.

The drivers behind this structural change are:

- **Cost.** There was increasing price competition from products made in developing countries, and it was recognised that costs could be saved by getting rid of many of the middle management layers.
- **Slow, poor communication.** The tall-narrow structure fragments the organisation and imposes many layers between the bottom and the top of the organisation. If Person A in the diagram above needs to communicate with the chief executive officer at the top, in a strictly run organisation, the message might have to pass through many layers of managers, leaving scope for delay, misunderstanding and distortion. If Person A needs to communicate with Person B, once again many managers might be involved. In stable environments, people at the bottom of organisations rarely needed to communicate with the top. However, nowadays, new recruits are likely to have valuable information that top management needs to know. For example, the use of social media such as Facebook in marketing and stakeholder communication.
- **Inflexibility.** Many layers of management imply many grades of pay and benefits and, if the organisation needed to change to respond to environmental developments, the large number of managers can be obstructive so as to defend their positions.

Moving to a flat-narrow configuration can address these problems. Note that the tall-narrow structure is likely to exhibit a role culture, whereas the wide-flat structure is more likely to have a task culture. The movement to wide-flat can also provide job enrichment because if a manager has more people to look after, less time can be given to each, and employees are therefore almost inevitably given more responsibility.

(2) Centralisation and de-centralisation

Centralisation means that most decision making is retained at the top of an organisation, and this implies a power culture. Decentralisation means that decision making is passed down through the group, and this brings the following advantages:

- Top management has more time to concentrate on the most important decisions.
- Decisions are made by technical experts, are made more quickly, and are made with an awareness of local conditions. The best person to decide about advertising in Brazil is almost certainly someone with a marketing background resident in Brazil, rather than a chief executive from an accounting background based in London.
- Motivation of staff. Giving decision-making responsibility is an excellent example of job enrichment.

On the downside, there is an increased chance of dysfunctional decision-making, where one division or department makes a decision that hurts the group overall. To reduce the chance of this, management needs to keep a coordinating role.

Specific Strategic Business Leader matters

1. The cultural web

This is usually depicted as follows:



The cultural web

In essence, this is a list of the factors that influence culture. It is a more detailed list than Schein's artifacts, espoused values, and basic assumptions and values. An approximate correlation between the two approaches is:

| Cultural web | | Schein |
|--------------------------|--|-----------|
| Symbols and titles | For example, how people dress and how they are addressed | Artifacts |
| Power relations | For example, autocratic or participative | Artifacts |
| Organisational structure | For example, tall-narrow or wide-flat | Artifacts |

| Cultural web | | Schein |
|------------------------------------|---|------------------------------|
| Control systems | For example, highly centralised or decentralised | Artifacts |
| Rituals and routines | For example, a regular start-of-week meeting | Espoused values |
| Myths and stories | For example, a story about when the organisation won an important client | Espoused values |
| Organisation assumption (paradigm) | For example, that the organisation exists to fulfil charitable objectives | Basic assumptions and values |

The cultural web is a very useful way of analysing organisational culture and could have been used to great effect in all of the questions mentioned at the start of this article.

2. Mintzberg's organisational configurations

Mintzberg suggested that an organisation consisted of five elements:

- **The strategic apex** – the board and top management.
- **The middle line** – middle managers responsible for carrying out the decisions of the strategic apex; the chain of command down through the organisation.
- **The operating core** – the workers.
- **Support staff** – departments such as accounting, personnel and IT.

- **The technocracy** – the people responsible for devising and enforcing standards and procedures such as the personnel manual, the internal control system, the quality control system, health and safety rules.

The size and importance of these elements depends on the type of organisation being described, and diagrams can be drawn to illustrate this, but the diagrams are not needed for the exam. The characteristics of three of Mintzberg's organisational stereotypes are as follows:

- **The simple structure.** This consists only off the strategic apex and the operating core: it is the boss and the workers and equates to Handy's power culture and to entrepreneurial organisations. Indeed, the simple structure is often known as the entrepreneurial structure.
- **Machine bureaucracy.** This refers to the structure that is common in mass-manufacturing industries. The middle line is lengthy, implying tall-narrow, with many management layers. The technocracy is large because in manufacturing companies, making large numbers of identical items, it is essential that production, quality, safety training and finance are carefully and repeatedly regulated.
- **The professional bureaucracy.** The professional bureaucracy. This refers to the structure that is typically found in firms of lawyers or accountants. The middle line is relatively short, implying wide-flat, with good communication between the top and bottom of the organisation. The technostructure is small because, although documentation can be standardised, each job is unique and is therefore not capable of standardisation. Because each job is unique, the partners (strategic apex) have to discuss directly the problems and findings of the accounting or legal staff who were closely involved with the work (the operating core). The professional form of organisation appears wherever the work of the organisation is dominated by skilled workers who use procedures that are difficult to learn, yet are well defined. Schools, universities and hospitals are prime examples.

Interaction of configuration and cultures

It is important to realise that cultures and configurations go hand-in-hand. Indeed, Mintzberg has said that 'configurations are not just cultures, nor even just power systems. *They are cultures.*'

For example, a tall-narrow hierarchical structure will usually imply a role culture and a machine bureaucracy with great emphasis on control, symbols, titles, and strict power relations. As mentioned earlier, this can work well in stable environments, where the

paradigm will often be based round efficiency and cost leadership. It is also needed in high-risk environments where careful supervision of subordinates is needed.

In contrast, a wide-flat structure will more often imply a task culture and a professional bureaucracy, with little emphasis on symbols of hierarchy, more participative decision making, and fewer stultifying controls. Here, the paradigm is more likely to be based around customer service, responsiveness, differentiation and innovation.

Application of culture and organisational configuration to scenarios

Culture and organisational configuration could be examined in the following contexts:

(1) Culture clashes

A good example of this can be illustrated where there is a power culture that a new employee tried (unsuccessfully) to change to a role culture. Another example can be where a new director attempted to change both structure and culture to the fury of established personnel.

A recent real-life example is seen in the Hewlett-Packard (HP) takeover of Autonomy. HP is predominantly a hardware company and employed about 350,000 people worldwide. Autonomy was a relatively young, entrepreneurial software company based in Cambridge, UK, and had about 3,700 employees. HP took over Autonomy in 2011 for \$12bn and all of Autonomy's top level executives had left within about nine months; about 25% Autonomy's staff also left, claiming that the bureaucracy they encountered at HP was more than they could bear. 'We kept a running tally of the number of HP staff to Autonomy staff on conference calls. The record was 52 to 1,' said a former employee (Financial Times, 24 May 2012). Given that one of the main reasons for the acquisition of Autonomy was to acquire software skills and brainpower, losing a large proportion of staff is probably not a good result for HP.

A clash of cultures is likely to continue to appear in future questions. It allows the examining team to examine aspects of culture and configuration in context without suggesting that one culture is better than another.

(2) Inappropriate cultures and configurations

For example, if an organisation wanted to change its generic strategy from cost leadership to differentiation, almost certainly both culture and configuration will have to change. A similar issue can be illustrated, where the work routines effectively excluded female staff and customers were treated as lazy and incompetent. The survival of some organisations is threatened by clinging to a culture that is no longer appropriate, either within the industry sector or within society as a whole. Culture and configuration have to be changed to allow survival – however hard that is on individuals currently employed in the company.

(3) Different stages of an organisation's lifecycle

Also there may be situations illustrating how a business's culture and structure changed throughout its lifecycle, and how it should be managed. The company may have started in an entrepreneurial/power culture with a charismatic leader who recruited like-minded employees. Formal controls could have been non-existent and the company was fun to work in. Later it could become listed and inevitably have to adopt much more of a role culture; controls will become tighter and public scrutiny will affect rituals, symbols and the organisational paradigm. Neither the founder nor existing staff may enjoy the new situation. Finally, the founder could buy back the company and tries to turn the clock back to earlier, happier days, but the staff then employed may dislike those changes.

(4) Change management

If a culture or organisation structure has to be changed, then the problem of change management arises. How can we encourage employees and other stakeholders to willingly embrace the change – or at least not to oppose it actively? Communication, education and participation in the change process are usually advised.

Conclusion

Culture and configuration is examinable in the SBL exam, particularly with reference to the cultural web and Mintzberg's configuration stereotypes. Candidates must ensure that they can apply theories and principles to the case study scenario. Mismatch of cultures and configurations is likely to be a recurring theme.

Adapted from an article originally written by Ken Garrett (a freelance author and lecturer)

Chapter 2 Ethical decision making

Executive Summary

Many business decisions have ethical elements to them. This is because of the impacts of those decisions, and the fact that outcomes are likely to affect stakeholders in different ways and will express different ethical values.

This article looks at two of the main decision-making frameworks which are 1) The American Accounting Association (AAA) model; 2) Tucker's 5-question model.

Introduction

In this article, two of the main decision-making frameworks from the SBL *Study Guide* are examined. In particular, this article clearly explains the two frameworks mentioned in *Study Guide* Section A3 – namely the American Accounting Association (AAA) model, and Tucker's 5-question model. In each case, we start with an explanation of the model before showing how it might be used in a case situation.

The American Accounting Association (AAA) model

The American Accounting Association (AAA) model comes from a report for the AAA written by Langenderfer and Rockness in 1990. In the report, they suggest a logical, seven-step process for decision making, which takes ethical issues into account.

The model begins, at Step 1, by establishing the facts of the case. While perhaps obvious, this step means that when the decision-making process starts, there is no ambiguity about what is under consideration. Step 2 is to identify the ethical issues in the case. This involves examining the facts of the case and asking what ethical issues are at stake. The third step is an identification of the norms, principles, and values related to the case. This involves placing the decision in its social, ethical, and, in some cases, professional behaviour context. In this last context, professional codes of ethics or the social expectations of the profession are taken to be the norms, principles, and values. For example, if stock market rules are involved in the decision, then these will be a relevant factor to consider in this step.

In the fourth step, each alternative course of action is identified. This involves stating each one, without consideration of the norms, principles, and values identified in Step 3, in order to ensure that each outcome is considered, however appropriate or inappropriate that outcome might be.

Then, in Step 5, the norms, principles, and values identified in Step 3 are overlaid on to the options identified in Step 4. When this is done, it should be possible to see which options accord with the norms and which do not. In Step 6, the consequences of the outcomes are considered. Again, the purpose of the model is to make the implications of each outcome

unambiguous so that the final decision is made in full knowledge and recognition of each one. Finally, in Step 7, the decision is taken.

Scenario for the AAA model

An auditor uncovers an irregular cash payment and receives an unsatisfactory explanation for it from the client's finance director. He suspects the cash payment is a bribe paid to someone but can't prove it. The client then offers to pay the auditor a large amount of money if he pretends not to have noticed the payment. The amount of money offered by the client is large enough to make a significant difference to the auditor's wealth. Should the auditor take the money?

Step 1: What are the facts of the case?

The facts are that the auditor has uncovered what he believes to be a bribe and has, in turn, been offered a bribe to ignore or overlook it.

Step 2: What are the ethical issues in the case?

The ethical issue is whether or not an auditor should accept a bribe. In accepting the bribe he would be acting illegally and would also be negligent of his professional duties.

Step 3: What are the norms, principles, and values related to the case?

The norms, principles, and values are that auditors are assumed (by shareholders and others active in capital markets) to have impeccable integrity and to assure that the company is providing a 'true and fair view' of its financial situation at the time of the audit. Auditors are entrusted with the task of assuring a company's financial accounts and anything that prevents this or interferes with an auditor's objectivity is a failure of the auditor's duty to shareholders.

Step 4: What are the alternative courses of action?

Option 1 is to accept the bribe and ignore the irregular cash payment. Option 2 is to refuse the bribe and take appropriate actions accordingly.

Step 5: What is the best course of action that is consistent with the norms, principles, and values identified in Step 3?

The course of action consistent with the norms, principles, and values in Step 3 is to refuse the bribe. The auditor would report the initial irregular payment and then also probably report the client for offering the second bribe.

Step 6: What are the consequences of each possible course of action?

Under Option 1, the auditor would accept the bribe. He would enjoy the increase in wealth and presumably an increase in his standard of living but he would expose himself to the risk of being in both professional and legal trouble if his acceptance of the bribe was ever uncovered. He would have to 'live with himself' knowing that he had taken a bribe and would be in debt to the client, knowing that the client could expose him at any time.

Under Option 2, the auditor would refuse the bribe. This would be likely to have a number of unfortunate consequences for the client and possibly for the future of the client–auditor relationship. It would, however, maintain and enhance the reputation and social standing of auditors, maintain public confidence in audit, and serve the best interests of the shareholders.

Step 7: What is the decision?

The ethical decision is Option 2. The auditor should refuse the bribe.

Tucker's 5-question model

This model is conceptually slightly different from the AAA model but is nevertheless a powerful tool for determining the most ethical outcome in a given situation. It might be the case that not all of Tucker's criteria are relevant to every ethical decision. If it were used when considering the AAA model scenario above, for example, there is no indication of the environmental relevance of the auditor's decision. In addition, the reference to profitability means that this model is often more useful for examining corporate rather than professional or individual situations.

Applying Tucker's model requires a little more thought than when using the AAA model in some situations, however. This is because three of the five questions (profitable, fair, and right) can only be answered by referring to other things. So when the model asks, 'is it profitable?', it is reasonable to ask, 'compared to what?' Similarly, whether an option is 'fair' depends on whose perspective is being adopted. This might involve a consideration of the stakeholders involved in the decision and the effects on them. Whether an option is 'right' depends on the ethical position adopted. A deontological perspective may well arrive at a different answer than a teleological perspective, for example. In order to see how Tucker's model might work in practice, we will consider two decision scenarios, one fairly clear cut and one that is a little more complicated.

Tucker: Scenario 1

Got it Pass eLearning Co**Supplementary Notes**

Big Company is planning to build a new factory in a developing country. Analysis shows that the new factory investment will be more profitable than alternatives because of the cheaper labour and land costs. The government of the developing country has helped the company with its legal compliance, which is now fully complete, and the local population is anxiously waiting for the jobs which will, in turn, bring much needed economic growth to the developing country. The factory is to be built on reclaimed 'brownfield' land and will produce a lower unit rate of environmental emissions than a previous technology.

Is it profitable?

Yes. The investment will enable the company to make a superior return than the alternatives. The case explains that these are 'because of the cheaper labour and land costs'.

Is it legal?

Yes. The government of the developing country, presumably very keen to attract the investment, has helped the company with its legal issues.

Is it fair?

As far as we can tell, yes. The only stakeholder mentioned in the scenario is the workforce of the developing country who, we are told, is 'anxiously waiting' for the jobs. The scenario does not mention any stakeholders adversely affected by the investment.

Is it right?

Yes. The scenario explains that the factory will help the developing country with 'much needed economic growth', and no counter - arguments are given.

Is it sustainable or environmentally sound?

Yes. The scenario specifically mentions an environmental advantage from the investment. So in this especially simplified case, the decision is clear as it passes each decision criteria in the 5-question model. In more complex situations, it is likely to be a much more finely balanced decision.

Tucker: Scenario 2

Some more information has emerged about Big Company's new factory in the developing country. The 'brownfield' land that the factory is to be built on has been forcefully requisitioned from a community (the 'Poor Community') considered as 'second class citizens' by the government of the developing country. The Poor Community occupied the land as a slum and now has nowhere to live.

Is it profitable? Yes.

The same arguments apply as before.

Is it legal?

It appears that the government of the developing country has no effective laws to prevent the forced displacement of the Poor Community and may be complicit in the forced removal. While the investment may not be technically illegal, it appears that the legal structures in the host country are not particularly robust and are capable of what amounts to the oppression of the Poor Community.

Is it fair?

While the issue of the much needed employment remains important, it must be borne in mind that the jobs are provided at the cost of the Poor Community's homes. This apparent unfairness to the Poor Community is a relevant factor in this question. The answer to 'is it fair?' will depend on the decision maker's views of the conflicting rights of the parties involved.

Is it right?

The new information invites the decision maker to make an ethical assessment of the rights of the Poor Community against the economic benefits of the investment. Other information might be sought to help to make this assessment including, for example, the legality of the Poor Community's occupation of the site, and options for rehousing them once construction on the site has begun.

Is it sustainable or environmentally sound?

Yes. The same arguments apply as before.

Using these models – in summary

In the exam, candidates may be asked to assess or evaluate a situation such as one of the above scenarios in order to evaluate and may decide to use one of these models as an effective way of justifying their decision. Although some marks will be available for remembering the questions in the model used, the majority of marks will be assigned for its application. If the situation is relatively complex, exam answers should reflect that complexity, showing, for example, the arguments for and against a given question in the model and also showing this in the final decision. In most situations, the models can be

used as a basis for identifying the factors that need to be addressed. In only the most clear-cut cases, or when the case provides a minimum of information, will the decision be straightforward.

In summary, these two models can be used to ensure that ethical considerations are included when making important leadership type decisions.

Both models contain distinct steps or questions that encourage the decision maker to recognise the ethical issues in a decision. The AAA model invites the decision maker to explicitly outline their norms, principles, and values, while Tucker's model allows for discussion and debate over conflicting claims (eg between different beliefs of what is 'fair' and 'right'). Both are potentially useful to senior decision makers and hence their inclusion as an important part of the SBL *Study Guide*.

Adapted from an article originally written by a member of the P1 examining team

Chapter 3 All about stakeholders Part 1

Executive Summary

Part 1 introduces the idea of stakeholders and stakeholding, and an explanation of the different ways in which stakeholders are categorised.

This article introduces the idea of stakeholders and stakeholding. It starts with definitions of the relevant terms, explains the nature of stakeholder 'claims', and then goes on to use the Mendelow framework to explain how stakeholding is linked to influence. Finally, it covers the different ways in which stakeholders are categorised and how they are distinguished from each other.

Definitions and examples

The subject of stakeholders features in section B4 of the Strategic Business Leader (SBL) syllabus. It is central to any understanding of the subject of business and organisational ethics. The purpose of this – and the next – article is to bring all aspects of the subject together so that students new to the field can gain an understanding of what the subject means and how it is constructed as far as ethics is concerned.

Any definition of a stakeholder must take into account the stakeholder–organisation relationship. The best definition of this is by Freeman, who in 1984 defined a stakeholder as: ‘Any group or individual who can affect or [be] affected by the achievement of an organisation’s objectives’. This definition shows the important bi-directionality of stakeholders – that they can be both affected by – and can affect – an organisation. Of course, some stakeholders will be in both camps.

When we think of stakeholders, it is possible to list many examples, but the ones that usually come to mind are shareholders, management, employees, trade unions, customers, suppliers, and communities. However, larger and more complex organisations can have many more stakeholders than these. Compare, for example, the different complexities of a small organisation, such as a corner shop or street trader, with a large international organisation such as a major university or ACCA. The first important aspect of stakeholder theory is, therefore, to recognise that stakeholders exist and that the complexity and range of stakeholders relevant to an organisation will depend on that organisation’s size and activities.

Stakeholder 'claims'

The reason why stakeholders are important in both business ethics and in strategic analysis is because of the notion of stakeholder ‘claims’. A stakeholder does not simply exist (as far as the organisation is concerned) but makes demands of it. This is where understanding stakeholding can become more complicated.

Essentially, stakeholders ‘want something’ from an organisation. Some want stakeholders to influence what the organisation does (those stakeholders who want to affect) and others

are, or potentially could be, concerned with the way they are affected by the organisation and may want to increase, decrease, or change the way the activities of the organisation affect them. One of the problems with identifying stakeholder claims, however, is that some stakeholders may not even know that they have a claim against an organisation, or may know they have a claim but are unaware of what it is. This brings us to the issue of direct and indirect stakeholder claims.

Direct stakeholder claims are made by those with their own 'voice'. These claims are usually unambiguous, and are often made directly between the stakeholder and the organisation. Stakeholders making direct claims will typically include trade unions, shareholders, employees, customers, suppliers and, in some instances, local communities.

Indirect claims are made by those stakeholders unable to make the claim directly because they are, for some reason, inarticulate or 'voiceless'. Although this means they are unable to express their claim direct to the organisation, it is important to realise that this does not invalidate their claim. Typical reasons for this lack of expression include the stakeholder being (apparently) powerless (eg an individual customer of a very large organisation), not existing yet (eg future generations), having no voice (eg the natural environment), or being remote from the organisation (eg producer groups in distant countries). This raises the problem of interpretation. The claim of an indirect stakeholder must be interpreted by someone else in order to be expressed, and it is this interpretation that makes indirect representation problematic. How do you interpret, for example, the needs of the environment or future generations? What would they say to an organisation that affects them if they could speak? To what extent, for example, are environmental pressure groups reliable interpreters of the needs (claims) of the natural environment? To what extent are terrorists reliable interpreters of the claims of the causes and communities they purport to represent? This lack of clarity on the reliability of spokespersons for these stakeholders makes it very difficult to operationalise (to include in a decision-making process) their claims.

Understanding the influence of each stakeholder (Mendelow)

In strategic analysis, the Mendelow framework is often used to attempt to understand the influence that each stakeholder has over an organisation's objectives and/or strategy. The idea is to establish which stakeholders have the most influence by estimating each

stakeholder's individual power over – and interest in – the organisation's affairs. The stakeholders with the highest combination of power and interest are likely to be those with the most actual influence over objectives. Power is the stakeholder's ability to influence objectives (how much they can), while interest is the stakeholder's willingness (how much they care).

$\text{Influence} = \text{Power} \times \text{Interest}$

There are issues with this approach, however. Although it is a useful basic framework for understanding which stakeholders are likely to be the most influential, it is very hard to find ways of effectively measuring each stakeholder's power and interest. The 'map' generated by the analysis of power and interest (on which stakeholders are plotted accordingly) is not static; changing events can mean that stakeholders can move around the map with consequent changes to the list of the most influential stakeholders in an organisation.

The organisation's strategy for relating to each stakeholder is determined by the part of the map the stakeholder is in. Those with neither interest nor power (top left) can, according to the framework, be largely ignored, although this does not take into account any moral or ethical considerations. It is simply the stance to take if strategic positioning is the most important objective. Those in the bottom right are the high-interest and high-power stakeholders, and are, by that very fact, the stakeholders with the highest influence. The question here is how many competing stakeholders reside in that quadrant of the map. If there is only one (eg management) then there is unlikely to be any conflict in a given decision-making situation. If there are several and they disagree on the way forward, there are likely to be difficulties in decision making and ambiguity over strategic direction.

Stakeholders with high interest (ie they care a lot) but low power can increase their overall influence by forming coalitions with other stakeholders in order to exert a greater pressure and thereby make themselves more powerful. By moving downwards on the map, because their power has increased by the formation of a coalition, their overall influence is increased. The management strategy for dealing with these stakeholders is to 'keep informed'.

Finally, those in the bottom left of the map are those with high power but low interest. All these stakeholders need to do to become influential is to re-awaken their interest. This will move them across to the right and into the high influence sector, and so the management strategy for these stakeholders is to 'keep satisfied'.

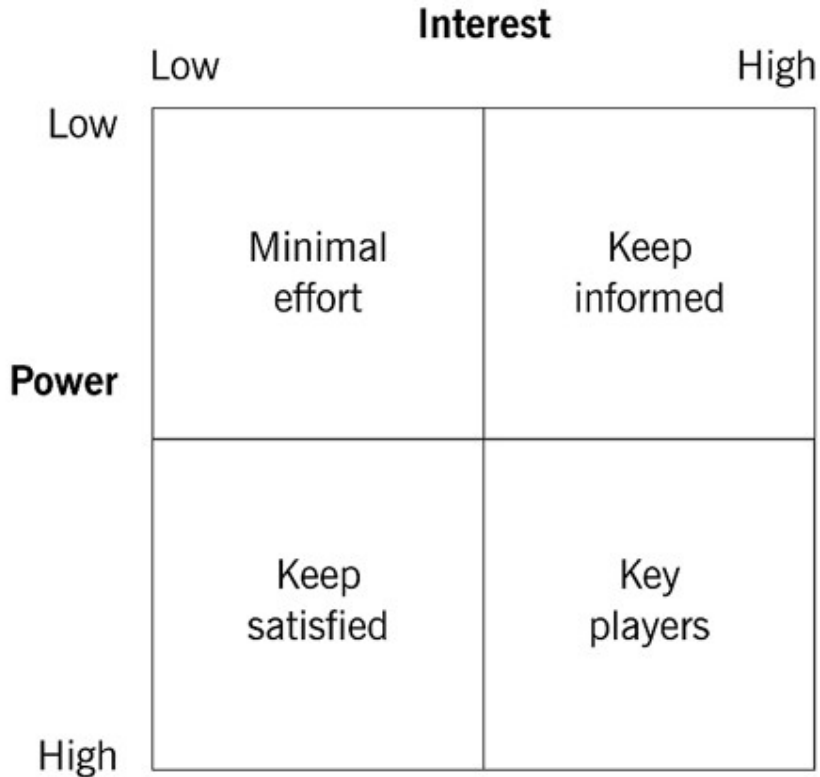


Figure 1 - The Mendelow Framework

How to categorise stakeholders

The Freeman definition is something of a 'catch all' and many writers in the field have found it helpful to develop other ways of distinguishing one type of stakeholder in an organisation from another.

Internal and external stakeholders

Perhaps the easiest and most straightforward distinction is between stakeholders inside the organisation and those outside. Internal stakeholders will typically include employees and management, whereas external stakeholders will include customers, competitors, suppliers, and so on. Some stakeholders will be more difficult to categorise, such as trade unions that may have elements of both internal and external membership.

Narrow and wide stakeholders (Evans and Freeman)

Narrow stakeholders are those that are the most affected by the organisation's policies and will usually include shareholders, management, employees, suppliers, and customers who are dependent upon the organisation's output. Wider stakeholders are those less affected and may typically include government, less-dependent customers, the wider community (as opposed to the local community) and other peripheral groups. The Evans and Freeman model may lead some to conclude that an organisation has a higher degree of responsibility and accountability to its narrower stakeholders.

Primary and secondary stakeholders (Clarkson)

According to Clarkson: 'A primary stakeholder group is one without whose continuing participation the corporation cannot survive as a going concern'. Hence, whereas Evans and Freeman view stakeholders as being (or not being) influenced by an organisation, Clarkson sees the important distinction as being between those that do influence an organisation and those that do not. Secondary stakeholders are those that the organisation does not directly depend upon for its immediate survival.

Active and passive stakeholders (Mahoney)

Mahoney (1994) divided stakeholders into those who are active and those who are passive. Active stakeholders are those who seek to participate in the organisation's activities. These stakeholders may or may not be a part of the organisation's formal structure. Management and employees obviously fall into this active category, but so may some parties from outside an organisation, such as regulators (in the case of, say, UK privatised utilities) and environmental pressure groups.

Passive stakeholders, in contrast, are those who do not normally seek to participate in an organisation's policy making. This is not to say that passive stakeholders are any less interested or less powerful, but they do not seek to take an active part in the organisation's strategy. Passive stakeholders will normally include most shareholders, government, and local communities.

Voluntary and involuntary stakeholders

This distinction describes those stakeholders who engage with the organisation voluntarily and those who become stakeholders involuntarily. Voluntary stakeholders will include, for example, employees with transferable skills (who could work elsewhere), most customers, suppliers, and shareholders. Some stakeholders, however, do not choose to be stakeholders but are so nevertheless. Involuntary stakeholders include those affected by the activities of large organisations, local communities and 'neighbours', the natural environment, future generations, and most competitors.

Legitimate and illegitimate stakeholders

This is one of the more difficult categorisations to make, as a stakeholder's legitimacy depends on your viewpoint (one person's 'terrorist', for example, is another's 'freedom fighter'). While those with an active economic relationship with an organisation will almost always be considered legitimate, others that make claims without such a link, or that have no mandate to make a claim, will be considered illegitimate by some. This means that there is no possible case for taking their views into account when making decisions.

While terrorists will usually be considered illegitimate, there is more debate on the legitimacy of the claims of lobby groups, campaigning organisations, and non-governmental/charitable organisations.

Recognised and unrecognised (by the organisation) stakeholders

The categorisation by recognition follows on from the debate over legitimacy. If an organisation considers a stakeholder's claim to be illegitimate, it is likely that its claim will not be recognised. This means the stakeholder's claim will not be taken into account when the organisation makes decisions.

Known about and unknown stakeholders

Finally, some stakeholders are known about by the organisation in question and others are not. This means, of course, that it is very difficult to recognise whether the claims of unknown stakeholders (eg nameless sea creatures, undiscovered species, communities in close proximity to overseas suppliers, etc) are considered legitimate or not. Some say that it is a moral duty for organisations to seek out all possible stakeholders before a decision is taken and this can sometimes result in the adoption of minimum impact policies.

For example, even though the exact identity of a nameless sea creature is not known, it might still be logical to assume that low emissions can normally be better for such creatures than high emissions.

Adapted from an article originally written by a member of the P1 examining team

Chapter 4 All about stakeholders Part 2

Executive Summary

Part 2 then goes on to focus on stakeholders and stakeholding by looking at a number of different stakeholder groups.

Who's who: the stakeholder/stockholder debate

The stakeholder/stockholder (or stakeholder/ shareholder) debate is at the heart of the ethical consideration of stakeholders and is central to the discussion as it separates people into political and ethical 'camps'. The term 'stockholder' rather than 'shareholder' was used more in American literature that discussed these issues and has been the more commonly used term to describe the belief that shareholders are the only stakeholder with a legitimate claim to influence.

Essentially, proponents of the stockholder theory argue that because organisations are 'owned' by their principals, the agents (directors) have a moral and legal duty to only take account of principals' claims when setting objectives and making decisions. Hence, for a joint stock business such as a public company, it may be assumed that because principals (shareholders) seek to maximise their returns, the sole duty of agents is to act in such a way as to achieve that.

Stakeholder theorists, in contrast, argue that because a business organisation is a citizen of society, enjoying its protection, support and benefits, it has a duty to recognise a plurality of claims in the same way that an individual might act as a 'responsible citizen'. In effect, this means recognising claims in addition to those of shareholders when reaching decisions and deciding on strategies.

Instrumental and normative motivations of stakeholder theory

Another debate, from an ethical perspective, is why organisations do or do not take account of stakeholder concerns in their decision making, strategy formulation, and implementation. A parallel can be drawn between the ways in which organisations view their stakeholders and the ways in which individual people consider (or do not consider) the views of others. Some people are concerned about others' opinions, while other people seem to have little or no regard for others' concerns. Furthermore, the reasons why individuals care about others' concerns will also vary.

In attempting to address this issue, Donaldson and Preston described two contrasting motivations: the instrumental and the normative.

The instrumental view of stakeholders

The instrumental view of stakeholder relations is that organisations take stakeholder opinions into account only insofar as they are consistent with other, more important, economic objectives (eg profit maximisation, gaining market share, compliance with a corporate governance standard). Accordingly, it may be that a business acknowledges stakeholders only because acquiescence to stakeholder opinion is the best way of achieving other business objectives. If the loyalty or commitment of an important primary or active stakeholder group is threatened, it is likely that the organisation will recognise the group's claim because not to do so would threaten to reduce its economic performance and profitability. It is therefore said that stakeholders are used instrumentally in the pursuit of other objectives.

The normative view of stakeholders

The normative view of stakeholder theory differs from the instrumental view because it describes not what is, but what should be. The most commonly cited moral framework used in describing 'that which should be' is derived from the philosophy of the German ethical thinker Immanuel Kant (1724–1804). Kant's moral philosophy centred around the notion of civil duties which, he argued, were important in maintaining and increasing overall good in society. Kantian ethics are, in part, based upon the notion that we each have a moral duty to each other in respect of taking account of each others' concerns and opinions. Not to do so will result in the atrophy of social cohesion and will ultimately lead to everybody being worse off morally and possibly economically.

Extending this argument to stakeholder theory, the normative view argues that organisations should accommodate stakeholder concerns not because of what the organisation can instrumentally 'get out of it' for its own profit, but because by doing so the organisation observes its moral duty to each stakeholder. The normative view sees stakeholders as ends in themselves and not just instrumental to the achievement of other ends.

Seven positions along the continuum: Gray, Owen and Adams

Let's return to the idea that the internal audit department is carrying out the delegated work of the audit committee. This is a fruitful area to explore because it explains some of the characteristics of effective (and ineffective) IA. The audit committee is made up of independent non-executive directors (NEDs). This isn't the place to explore the concept of independence in detail, but independence is central to an effective IA department. The work of IA becomes meaningless if it is compromised by management influence. Achieving independence is difficult, and made more so because internal auditors are usually employees of the company.

The stakeholder/stockholder debate can be represented as a continuum, with the two extremes representing the 'pure' versions of each argument. But as with all continuum constructs, 'real life' exists at a number of points along the continuum itself. It is the ambiguity of describing the different positions on the continuum that makes Gray, Owen and Adams's 'seven positions on social responsibility' so useful.

Pristine capitalists

At the extreme stockholder end is the pristine capitalist position. The value underpinning this position is shareholder wealth maximisation, and implicit within it is the view that anything that reduces potential shareholder wealth is effectively theft from shareholders. Because shareholders have risked their own money to invest in a business, and it is they who are the legal owners, only they have any right to determine the objectives and strategies of the business. Agents (directors) that take actions, perhaps in the name of social responsibility, that may reduce the value of the return to shareholders, are acting without mandate and destroying value for shareholders.

Expedients

The expedient position shares the same underlying value as that of the pristine capitalist (that of maximising shareholder wealth), but recognises that some social responsibility expenditure may be necessary in order to better strategically position an organisation so as to maximise profits. Accordingly, a company might adopt an environmental policy or give

money to charity if it believes that by so doing, it will create a favourable image that will help in its overall strategic positioning.

Social contract position

The notion of social contract has its roots in political theory. Democratic governments are said to govern in a social contract with the governed. This means that a democratic government must govern broadly in line with the expectations, norms and acceptations of the society it governs and, in exchange, society agrees to comply with the laws and regulations passed by the government. Failure by either side to comply with these terms will result in the social contract being broken. For businesses, the situation is a little more complex because unlike democratic governments, they are not subject to the democratic process.

The social contract position argues that businesses enjoy a licence to operate and that this licence is granted by society as long as the business acts in such a way as to be deserving of that licence. Accordingly, businesses need to be aware of the norms (including ethical norms) in society so that they can continually adapt to them. If an organisation acts in a way that society finds unacceptable, the licence to operate can be withdrawn by society, as was the case with Arthur Andersen after the collapse of Enron.

Social ecologists

Social ecologists go a stage further than the social contractarians in recognising that (regardless of the views of society), business has a social and environmental footprint and therefore bears some responsibility in minimising the footprint it creates. An organisation might adopt socially and/or environmentally responsible policies not because it has to in order to be aligned with the norms of society (as the social contractarians would say) but because it feels it has a responsibility to do so.

Socialists

In the context of this argument, socialists are those that see the actions of business as those of a capitalist class subjugating, manipulating, and even oppressing other classes of people. Business is a concentrator of wealth in society (not a redistributor) and so the task of business, social, and environmental responsibility is very large – much more so than merely adopting token policies (as socialists would see them) that still maintain the

supremacy of the capitalist classes. Business should be conducted in a very different way – one that recognises and redresses the imbalances in society and provides benefits to stakeholders well beyond the owners of capital.

Radical feminists

Like the socialists, radical feminists (not to be confused with militants, but rather with a school of philosophy) also seek a significant re adjustment in the ownership and structure of society. They argue that society and business are based on values that are usually considered masculine in nature such as aggression, power, assertiveness, hierarchy, domination, and competitiveness. It is these emphases, they argue, that have got society and environment in the 'mess' that some people say they are in. It would be better, they argue, if society and business were based instead on values such as connectedness, equality, dialogue, compassion, fairness, and mercy (traditionally seen as feminine characteristics). This would clearly represent a major challenge to the way business is done all over the world and hence would require a complete change in business and social culture. This theory relates to Hofstede's 'cultural dimensions' introduced in the Paper F1 syllabus.

Deep ecologists

Finally, the deep ecologists (or deep greens) are the most extreme position of coherence on the continuum. Strongly believing that humans have no more intrinsic right to exist than any other species, they argue that just because humans are able to control and subjugate social and environmental systems does not mean that they should. The world's ecosystems of flora and fauna, the delicate balances of species and systems are so valuable and fragile that it is immoral for these to be damaged simply (as they would see it) for the purpose of human economic growth.

There is (they argue) something so wrong with existing economic systems that they cannot be repaired as they are based on completely perverted values. A full recognition of each stakeholders' claim would not allow business to continue as it currently does and this is in alignment with the overall objectives of the deep ecologists or deep greens.

The audit committee is one of the vital parts of the committee structure of sound corporate governance. Its role in overseeing IA is important because it is the audit committee that ensures that the IA function actually supports the strategic objectives of the company (and doesn't act purely on its own initiative). In addition, though, it is likely that the audit

committee – at the strategic level – will not only provide the IA function with the authority it needs to scrutinise the internal controls, but also to ensure that its work is actually supporting and providing the compliance needs of the company. It is part of ensuring the hierarchical congruence or consistency necessary in sound governance and strategic management.

Members of the IA function may encounter ethical threats (such as familiarity, self review, independence threats, and so on). An accountant working as an internal auditor, for example, may be unwilling to criticise the CFO if he believes the CFO has an influence on his future prospects with the company. Someone coming into IA from an operational position could also be exposed to a self-review threat. Even where external contractors are used to carry out the IA function, they are acting on behalf of management. To avoid this, and other ethical threats, internal audit work is one of the jobs expressly forbidden to external auditors under the terms of the Sarbanes–Oxley Act in the US, indicating just how valuable a characteristic independence is for all auditors (other codes have similar provisions).

There are some inherent limitations in what an IA department can achieve. Although corporate scandals sometimes arise from failings in operational level controls, there are also examples where the problem is a failure of strategic level controls, either arising from management override of controls (as at Enron) or through poor strategic level decisions (as at some of the banks that required state support in the 2008 banking crisis). Even in companies where excellent procedures are put in place to assess operational level controls, it is hard to imagine how IA can fully monitor strategic controls. It would be very hard to design a corporate governance structure in which even the most independent IA department had a mechanism to do much more than check that procedures have been followed at board level. The board ultimately has to be responsible for the proper working of strategic level controls. This is also illustrative of the way IA fits in to overall corporate governance. The corporate governance big picture has to be addressed if IA is going to be effective. A domineering CEO cannot be countered by the existence of an IA department. Indeed, interference in the work of internal audit would indicate broader corporate governance problems.

Conclusion

The issue of stakeholders lies at the heart of most discussions of ethics, and, accordingly, is very important for the Strategic Business Leader (SBL) exam. Being able to identify the

stakeholders mentioned in a case scenario, and describing their individual claims upon an organisation, is likely to be an important skill for SBL candidates to develop.

In addition, being able to identify the ethical viewpoints of people in a case scenario, perhaps with regard to stakeholder/ stockholder perspectives, or using Gray, Owen and Adams's positions, is also important. The various ways of categorising stakeholders is helpful for any stakeholder analysis but a general appreciation that business decisions are affected by and can affect many people and groups both inside and outside of the business itself, is fundamental to an understanding of the importance of stakeholders.

Adapted from an article originally written by a member of the P1 examining team

Chapter 5 The integrated report framework

Executive Summary

In 2013, the International Integrated Reporting Council (IIRC) released a framework for integrated reporting. The framework establishes principles and concepts that govern the overall content of an integrated report.

Introduction

In 2013, the International Integrated Reporting Council (IIRC) released a framework for integrated reporting. This followed a three-month global consultation and trials in 25 countries.

The framework establishes principles and concepts that govern the overall content of an integrated report. An integrated report sets out how the organisation's strategy, governance, performance and prospects, which lead to the creation of value. There is no benchmarking for the above matters and the report is aimed primarily at the private sector but it could be adapted for public sector and not-for-profit organisations.

The primary purpose of an integrated report is to explain to providers of financial capital how an organisation creates value over time. An integrated report benefits all stakeholders interested in a company's ability to create value, including employees, customers, suppliers, business partners, local communities, legislators, regulators and policymakers, although it is not directly aimed at all stakeholders. Providers of financial capital can have a significant effect on the capital allocation and attempting to aim the report at all stakeholders would be an impossible task and would reduce the focus and increase the length of the report. This would be contrary to the objectives of the report, which is value creation.

Historical financial statements are essential in corporate reporting, particularly for compliance purposes, but do not provide meaningful information regarding business value. Users need a more forward-looking focus without the necessity of companies providing their own forecasts and projections. Companies have recognised the benefits of showing a fuller picture of company value and a more holistic view of the organisation.

The International Integrated Reporting Framework will encourage the preparation of a report that shows their performance against strategy, explains the various capitals used and affected, and gives a longer-term view of the organisation. The integrated report is creating the next generation of the annual report as it enables stakeholders to make a more informed assessment of the organisation and its prospects.

Principle-based framework

The IIRC has set out a principle-based framework rather than specifying a detailed disclosure and measurement standard. This enables each company to set out its own report rather than adopting a checklist approach. The culture change should enable companies to communicate their value creation better than the often boilerplate disclosures under IFRS. The report acts as a platform to explain what creates the underlying value in the business and how management protects this value. This gives the report more business relevance rather than the compliance led approach currently used.

Integrated reporting will not replace other forms of reporting but the vision is that preparers will pull together relevant information already produced to explain the key drivers of their business's value. Information will only be included in the report where it is material to the stakeholder's assessment of the business. There were concerns that the term 'materiality' had a certain legal connotation, with the result that some entities may feel that they should include regulatory information in the integrated report. However, the IIRC concluded that the term should continue to be used in this context as it is well understood.

The integrated report aims to provide an insight into the company's resources and relationships that are known as the capitals and how the company interacts with the external environment and the capitals to create value. These capitals can be financial, manufactured, intellectual, human, social and relationship, and natural capital, but companies need not adopt these classifications. The purpose of this framework is to establish principles and content that governs the report, and to explain the fundamental concepts that underpin them. The report should be concise, reliable and complete, including all material matters, both positive and negative in a balanced way and without material error.

Integrated reporting is built around the following key components:

1. Organisational overview and the external environment under which it operates
2. Governance structure and how this supports its ability to create value
3. Business model
4. Risks and opportunities and how they are dealing with them and how they affect the company's ability to create value
5. Strategy and resource allocation
6. Performance and achievement of strategic objectives for the period and outcomes

7. Outlook and challenges facing the company and their implications
8. The basis of presentation needs to be determined, including what matters are to be included in the integrated report and how the elements are quantified or evaluated.

The framework does not require discrete sections to be compiled in the report but there should be a high level review to ensure that all relevant aspects are included. The linkage across the above content can create a key storyline and can determine the major elements of the report such that the information relevant to each company would be different.

Relationship with stakeholders

An integrated report should provide insight into the nature and quality of the organisation's relationships with its key stakeholders, including how and to what extent the organisation understands, takes into account and responds to their needs and interests. Further, the report should be consistent over time to enable comparison with other entities.

South African organisations have been acknowledged as among the leaders in this area of corporate reporting with many listed companies and large state-owned companies having issued integrated reports. An integrated report may be prepared in response to existing compliance requirements – for example, a management commentary. Where that report is also prepared according to the framework, or even beyond the framework, it can be considered an integrated report. An integrated report may be either a standalone report or be included as a distinguishable part of another report or communication. For example, it can be included in the company's financial statements.

The IIRC considered the nature of value and value creation. These terms can include the total of all the capitals, the benefit captured by the company, the market value or cash flows of the organisation and the successful achievement of the company's objectives. However, the conclusion reached was that the framework should not define value from any one particular perspective because value depends upon the individual company's own perspective. It can be shown through movement of capital and can be defined as value created for the company or for others. An integrated report should not attempt to quantify value as assessments of value are left to those using the report.

Many respondents felt that there should be a requirement for a statement from those 'charged with governance' acknowledging their responsibility for the integrated report in

order to ensure the reliability and credibility of the integrated report. Additionally, it would increase the accountability for the content of the report.

The IIRC feels the inclusion of such a statement may result in additional liability concerns, such as inconsistency with regulatory requirements in certain jurisdictions, and could lead to a higher level of legal liability. The IIRC also felt that the above issues might result in a slower take-up of the report and decided that those 'charged with governance' should, in time, be required to acknowledge their responsibility for the integrated report while, at the same time, recognising that reports in which they were not involved would lack credibility.

There has been discussion about whether the framework constitutes suitable criteria for report preparation and for assurance. The questions asked concerned measurement standards to be used for the information reported and how a preparer can ascertain the completeness of the report.

There were concerns over the ability to assess future disclosures, and recommendations were made that specific criteria should be used for measurement, the range of outcomes and the need for any confidence intervals be disclosed. The preparation of an integrated report requires judgment but there is a requirement for the report to describe its basis of preparation and presentation, including the significant frameworks and methods used to quantify or evaluate material matters. Also included is the disclosure of a summary of how the company determined the materiality limits and a description of the reporting boundaries.

The IIRC has stated that the prescription of specific KPIs and measurement methods is beyond the scope of a principles-based framework. The framework contains information on the principle-based approach and indicates that there is a need to include quantitative indicators whenever practicable and possible. Additionally, consistency of measurement methods across different reports is of paramount importance. There is outline guidance on the selection of suitable quantitative indicators.

A company should consider how to describe the disclosures without causing a significant loss of competitive advantage. The entity will consider what advantage a competitor could actually gain from information in the integrated report, and will balance this against the need for disclosure.

Companies struggle to communicate value through traditional reporting. The framework can prove an effective tool for businesses looking to shift their reporting focus from annual financial performance to long-term shareholder value creation. The framework will be

attractive to companies who wish to develop their narrative reporting around the business model to explain how the business has been developed.

Chapter 6 Corporate governance from the inside out

Executive Summary

This article explains that effective corporate governance has both internal and external drivers. Although directors and managers of companies may have little influence over the external regulatory framework, they can and must play their part in ensuring effective internal governance and compliance from deep within their own organisations.

Introduction

Although directors and managers of companies may have little influence over the external regulatory framework, they can and must play their part in ensuring effective internal governance and compliance from deep within their own organisations.

This should extend beyond external financial reporting and corporate governance structures into more operational areas of business management. By promoting deep-rooted corporate governance ideals within their own organisations, a culture of stakeholder focus and individual and corporate responsibility, for the common good, can flourish.

This article first briefly introduces agency theory and the agency problem, which recognises that the interests of the shareholders and of the board of directors may sometimes conflict and how issues relating to this problem brought about the need for corporate governance codes in the first place. It then examines the traditional stewardship concept that underlies conventional corporate governance within an external financial reporting framework.

The article then compares 'rules' versus 'principles' based codes and the implementation of governance within organisations. It argues that a broader and longer-term view of agency theory, such as applies to a wider group of stakeholders can engender a better team spirit that will help promote a culture of pro-stakeholder behaviour and positive attitudes at all levels of the organisation. The important links between corporate governance and corporate culture and values are also highlighted.

Agency theory

Under the narrowest of perspectives the principal objective of a company has traditionally been to maximise profits and thereby add to the wealth of its shareholders. However, the degree to which the pursuit of profit and wealth dominates depends upon the society's view of 'agency theory'. The questions to ask are; who discharges responsibility; who is accountable and what particular structure of relationships and potential conflicts exist between 'principals' and their 'agents'.

In business the stakeholder is known as the 'principal' and the officers of the company or the directors are known as the 'agents'. The extent to which boards of directors act in the interests of shareholders and in the pursuit of fiduciary interests such as wealth maximisation is determined by which of the seven perspectives is taken on corporate social responsibility; Gray, Owen and Adams (1996).

The stewardship concept

Generally it is accepted that the rights of shareholders and other stakeholders connected with the company should be protected and promoted by 'stewards' of these stakeholders and their interests, Argenti (1997) and Campbell (1997).

In theory, agents should be held responsible and accountable for balancing the conflicting interests of a whole range of stakeholders of the company.

The traditional 'pristine capitalist' view of 'stewardship' implies that the rights of the shareholders and the pursuit of their wealth are of paramount importance (Sternberg 1998). However, the banking crisis and spectacular corporate failures such as Enron and World Com would indicate that even the narrower interests of owners can often be neglected or ignored, along with those of a much wider group of stakeholders, including the general public.

The separation of ownership and control

The introduction of the limited company as a legal entity was a great advance from the private solely owned business or the partnership in that it greatly increased the supply of long-term funds to industry and commerce, and contributed to the creation of far more wealth within the global economy. The concepts of shareholdings and limited liability encouraged many more people of moderate means to invest their disposable income in businesses and at much lower risk than would hitherto have been possible within unincorporated organisations. With many more investors, many of whom have little or no business acumen, came the need to divorce ownership and control for practical purposes, and to introduce a 'court' or board of directors, as the 'agents' of this disparate group. This is the basis of what became the public limited company, a separation of ownership and control. This is a normal arrangement these days and it is hardly ever questioned.

'The trade of a joint stock company is always managed by a court of directors. This court, indeed, is frequently subject, in many respects, to the control of a general court of proprietors. But the greater part of those proprietors seldom pretend to understand anything of the business of a company...'

Adam Smith (1776), p408

The separation of ownership and control, and the disparity and inexperience of shareholders in business and financial matters, as Adam Smith recognised, would be problematic unless some system of external governance was imposed to safeguard the interests of these owners. The separation of ownership and control, and the potential divergence of the interests of owners and managers, is the main reason why there is a need for a system of corporate governance.

Adam Smith also recognised the problem of the separation of control and ownership interests within companies:

'....The directors of such companies, however, being the managers rather of other peoples money rather than their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own.... Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company'

Adam Smith (1776), p408

Clearly it was recognised as long ago as 1776 that the 'agency' model within the corporate context would not naturally work to the advantage of the principals without some intervention.

The legal and professional framework

Successive Companies Acts throughout the world from 1844 in the UK, have laid down increasingly complex layers of legislation about the constitution, the format, the minimum disclosure requirements, about the use of reserves, the maintenance of capital, and the general protection of creditors. In addition there has been a legal requirement for an 'independent' external audit of the financial disclosures of a company's affairs on a periodic basis to be carried out by competent and qualified professionals.

One of the major responsibilities of company directors is to ensure that the financial reports of companies are relevant and faithfully represent the affairs of the company and that stakeholders can make rational decisions based on the qualitative characteristics of the reports that are published (they are a 'true and fair' representation of the state of the company's finances at a given point in time). Auditing is mainly concerned with the faithful representation aspect of financial information.

Companies in most countries are by law required to have their accounts audited at the end of every financial period. A major aspect of most external corporate governance codes is about ensuring that the role of the auditor is effective and the relationship between the auditors and directors has integrity and is independent and objective. The issues to consider here are who should appoint the auditors, how long should the same firm of auditors be used repeatedly, and should firms of auditors, or even their subsidiaries or associates be providing consulting services to their clients?

Corporate governance

Corporate governance can be seen as having internal and external sources, where external corporate governance consists of mandatory and voluntary codes, reports and frameworks such as company law, stock market listing rules and accounting and auditing standards. Internal corporate governance is how such external governance is complied with and embedded within the culture and values of the organisation and how sound governance is implemented and works in practice.

The corporate governance framework can play its part in providing a structure for governing the behaviour of companies and their officers, but external rules, regulations, and codes of practice are not effective unless a climate of compliance within organisations is promoted to support such structures and mechanisms at all levels through such mechanisms as corporate and ethical codes of behaviour and values. There also needs to be a deeper culture embedded within companies, recognising the responsibilities and duties of management with regard to the legitimate rights of their stakeholders and shareholders.

Effective corporate governance is about promoting this climate of transparency, scepticism and objectivity; by creating systems, procedures, and internal structures, aimed at complying with external requirements, but also pre-empting and dissuading anti-stakeholder behaviour from deep within the organisation. Internal corporate governance (or the corporate culture) should therefore be instrumental in reducing the 'expectations gap'

between the interests and motivations of the 'agent' and those of the 'principal'; thereby addressing the agency problem at all levels within the organisation.

Principles or rules-based codes of corporate governance

Corporate governance structures can be voluntarily complied with and any departures from best practice can be explained in the notes to the accounts. The main benefit of this 'principles based' approach is that full compliance is often difficult for companies in specific situations or in special circumstances. 'Rules-based' compliance is a 'one size fits all' (box ticking) approach where full compliance is required by law and where departures can entail legal sanctions. This approach, such as adopted in the USA, is felt to be more effective because it doesn't rely as heavily on the integrity of the boards of directors to interpret and comply or explain openly and objectively.

Corporate governance is based on voluntary control in many countries, such as in the UK and is often a requirement for stock exchange listing. It is based on the adoption of specific board sub-committees and structures with clear recommendations relating to sound internal financial and operational controls and the promotion of high quality financial information to strengthen the accountability of boards of directors to their shareholders.

The Cadbury Code, (1992) was designed to concentrate on the essential internal control mechanisms to support this need for greater transparency and accountability to shareholders, which at the time was felt to be deficient. This voluntary report highlighted the ways in which companies could better underpin a company's legal and regulatory obligations to its shareholders through accountability and control, viewing the role of the non-executive director (NED) as being critical from an independence perspective.

The recommendations of the Cadbury Report emphasised higher standards of corporate governance through improvements in the quality of financial reporting. This aspect has also been supported by accounting standards bodies nationally and internationally, striving to provide more consistency, relevance, and understandability within the process of accounting for financial transactions and for reporting income, assets and liabilities. The

Cadbury report (1992) and others, were eventually enforced as listing rules on many stock exchanges.

The Cadbury Report recommended that external auditing should be more independent and closely monitored through the introduction of audit committees composed of a minimum number of non-executive directors (NEDs). However, where corporate governance was to have most impact was through the introduction of robust internal control mechanisms and a system of internal audit where the design and control of processes and continuous monitoring of transactions and decision-making can help safeguard assets and prevent and detect anti-stakeholder behaviour within the organisation. The concept of internal control was to be based on promoting continuous vigilance by management in preventing financial loss through fraud, error, inefficiency or incompetence.

There are many corporate governance codes, published around the world focusing on such matters as the role of the boards of directors and on how they are constituted. These include various recommendations on the procedures to appoint directors, the qualifications of directors, the proportion and independence and effectiveness of non-executive directors (Higgs 2003) and their diversity (Tyson 2003), and on the need for additional and independent board committees such as audit (Smith 2008), nomination, risk and remuneration committees. Indeed many corporate scandals (pre-Enron) tended to revolve around inappropriate or unjustified pay increases or bonuses for executives, seemingly regardless of performance, leading to so called 'fat cat' scandals. Both the Greenbury Report (1995), and the Hampel Report (1998), have focused their attention on directors' remuneration, rather than upon broader and more significant financial, performance or governance issues, because it was seen as being such a problem.

The main recommendations of the above committees were subsequently incorporated by the Turnbull Committee into the original Combined Code of the Committee on Corporate Governance in 1999, but this code also emphasised the broader responsibility of companies with respect to safeguarding shareholders' interests.

'The board should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets'

Principle D.2 – Combined Code May 1999

The combined code has been revised since 1999, and in 2010 it included several new recommendations. Eventually various versions of the UK Corporate Governance Code were published (FRC, 2014). These various iterations of the combined codes include the

requirement for the company chairman to be re-elected annually and to encourage greater diversity (specifically gender diversity) of the board. The revised code also requires more emphasis on the board of directors' performance in the larger companies being independently reviewed on a regular basis. It requires disclosure of the business model and responsibilities relating to risk; such as how much risk the company can accept and how much it will need to avoid, reduce or transfer. These new requirements link well with new proposals for a broader corporate reporting framework relating to integrated reporting <IR> (IIRC, 2013).

The revised combined code also makes new recommendations about the need to align remuneration of directors to longer-term performance metrics and having a closer interface between non-executive directors and the executive directors. The changes also include the chairman's responsibility relating to identifying the training and development needs of directors and around more effective external communications with shareholders, including institutional investors.

More effective company law, listing rules, regulations, accounting and auditing standards and corporate governance codes have clearly provided a better structure and basis for the governance of companies' behaviour in relation to the original agency problem. Whether these governance structures are principles or rules-based, the essential agency problem still seems to remain, as highlighted by continuing evidence of director failings and further corporate failures.

Reliance on voluntary codes, professional standards, and even on legislation may not provide an adequate safeguard against governance failure unless boards of directors, on behalf of stakeholders, set a clear 'tone from the top' and actively create a culture of transparency, honesty, and integrity within their organisations at all levels.

Corporate governance and cultural values

For corporate governance to be effective and for the interests of stakeholders to be properly safeguarded, a climate should be created where those working for the stakeholders and on behalf of them, are conscious of the ultimate economic, social and ethical consequences of their decisions and behaviour (at whatever level).

Directors should therefore promulgate and inculcate within their organisations a climate of responsibility, accountability, and transparency. This can be achieved by the use of formal

structures such as audit and remuneration committees, by appointing effective and independent non-executive directors, and by tightening up on auditing regulations, but it is mainly achieved by having a sustainable, longer-term and broader perspective and by encouraging all to act ethically.

Companies can encourage such behaviour by designing appropriate corporate codes of ethics and behaviour within organisations, supported by a system of cultural values which are themselves linked to individual performance appraisal and professional development.

For example, promoting consonance between the aims of primary stakeholders and those of other stakeholders can create a team spirit where all perceive they are working for a common purpose or goal. This common purpose can also be reinforced by having a clear corporate mission and setting strategic aims and objectives which are coherent and sustainable and which can be broken down into meaningful and measurable departmental and team objectives that all within the organisation can buy into and relate to.

This kind of climate is promoted by such instruments as:

- equitable productivity and bonus schemes
- transparent recruitment and promotion policies
- good staff welfare and reward systems
- effective environmental policies, and
- good customer relations.

All of these are based on an overriding quality culture, where effectiveness and efficiency are promoted and every aspect of the organisations activities are considered to be important at all levels, where people of all levels are valued and respected and where the impact of all decisions on the interests of stakeholders is always recognised and anticipated.

Good governance therefore must, by implication, extend beyond basic compliance with external reporting and auditing requirements, to such areas as internal control, performance measurement and management, budgetary control systems, quality management, staff recruitment, training and development, and to reward and promotion systems within a business organisation.

Conclusion

A business that embraces the underlying principles as well as 'being seen' to be compliant with corporate governance codes is better placed to protect the interests of its stakeholders, including the public interest, from a more sustainable and longer-term perspective.

This wider view of agency theory is in stark contrast to the narrower 'stewardship' perspective, but whichever perspective is taken, corporate governance and all it entails is an essential framework within which the rights, responsibilities, and rewards available to the principals and their agents is best balanced.

The development of an informal corporate culture and of ethical values to underpin and support formal corporate governance structures is essential. This approach reduces the risk of negative behaviours such as, wastefulness, inefficiency, idleness, greed, fraud, deception, bribery or theft occurring or being tolerated.

Such a business culture can sustainably meet and balance the needs of shareholders, lenders, employees, suppliers, customers, and the general public, recognising their respective interests as being entirely compatible over the longer term.

This balance can only be realistically achieved if effective acceptance of corporate social responsibility, rather than compliance with governance structures alone, becomes part of the 'mindset' of all those working in business organisations; so that accountability and responsibility to all stakeholders is delivered from the inside out.

References:

- Argenti, J (1997) Stakeholders: The Case Against Long Range Planning, 30(3), 442-445
- Cadbury Committee, (1992), Report of the Committee on the Financial aspects of Corporate Governance, London, Gee
- Campbell A, (1997), Stakeholders: The Case in Favour of Long Range Planning. Long Range Planning, International Journal of Strategic Management, (30)3, 446-449
- Financial Reporting Council (2010), Revisions to the UK Corporate Governance Code UK (formerly the Combined Code), FRC
- Financial Reporting Council (2014), [UK Corporate Governance Code](#), FRC

Got it Pass eLearning Co**Supplementary Notes**

- Gray, R., Owen, D. and Adams, C. (1996) Accounting and Accountability; Changes and Challenges in Corporate Social and Environmental Reporting, Harlow: Prentice Hall Europe
- Greenbury Committee, (1995), '[Directors' Remuneration – Report of a Study Group](#)', chaired by Sir Richard Greenbury
- Hampel Committee, (1998), Committee on Corporate Governance – Final Report, London, Gee
- Higgs (2003), '[Review of the Role and Effectiveness of Non-executive Directors](#)'
- IIRC, 'The International <IR> Framework' (Dec 2013), published by the IIRC
- Smith A, (1776), '[An Inquiry into the Nature and Causes of the Wealth of Nations](#)', Feedbooks
- Smith Committee (2008), Consultation on Proposed Changes to Guidance on Audit Committees, (The Smith Guidance)
- Sternberg, E (1998) Corporate Governance: Accountability in the Marketplace, Hobart, Paper 137, Institute of Economic Affairs
- Turnbull Committee, (1998), Combined Code – Principles of Good Governance and Code of Best Practice
- Turnbull Committee, (1999), Internal Control – Guidance for Directors on the Combined Code
- [Tyson Report \(2003\)](#)

Adapted from an article originally written by a member of the P1 examining team

Chapter 7 Diversifying the board – a step towards better governance

Executive Summary

Introduces the concept of board diversity and how it may benefit the organisation, followed by a discussion on the possible costs of board diversity. It concludes with a comment on the current regulatory initiatives of board diversity.

Introduction

The board of directors forms one of the pillars of a robust corporate governance framework. This is evidenced by the Organisation for Economic Co-operation and Development (OECD) Principles of Corporate Governance stating that:

'the corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders'.

This, in turn, links to the fundamental concepts of corporate governance – namely, judgment, responsibility and accountability.

Recent academic literature suggests that one of the ways to enhance corporate governance, arguably, is to diversify the board. In the Strategic Business Leader (SBL) *Study Guide*, section B5e requires students to (i) explain the meaning of 'diversity' and (ii) critically evaluate issues of diversity on the board of directors.

This article attempts to elaborate on this topic by first introducing the concept of board diversity and how it may benefit the organisation, which is followed by a discussion on the possible costs of board diversity.

The article will then conclude with a comment on the current regulatory initiatives of board diversity.

Definition of board diversity

Over the years, regulators have placed great emphasis on addressing different matters relating to the board of directors. Two prominent examples were: (i) stressing on the roles of non-executive directors as well as the importance of independence of the board in the Higgs Review in 2003; and (ii) emphasising the significance of balancing skills and experience of the board members as in the Walker Review in 2010. Until recently, there has been an urge for diversifying the board. Intuitively, diversity means having a range of many people that are different from each other.

There is, however, no uniform definition of board diversity. Traditionally speaking, one can consider factors like age, race, gender, educational background and professional qualifications of the directors to make the board less homogenous. Some may interpret board diversity by taking into account such less tangible factors as life experience and personal attitudes.

In short, board diversity aims to cultivate a broad spectrum of demographic attributes and characteristics in the boardroom. A simple and common measure to promote heterogeneity in the boardroom – commonly known as gender diversity – is to include female representation on the board.

Benefits of board diversity

Diversifying the board is said broadly to have the following benefits:

- More effective decision making.
- Better utilisation of the talent pool.
- Enhancement of corporate reputation and investor relations by establishing the company as a responsible corporate citizen.

1. More effective decision making

It is believed that a diverse board is able to make decisions more effectively by reducing the risk of 'groupthink', paying more attention to managing and controlling risks as well as having a better understanding of the company's consumers. These benefits are further elaborated below.

Directors are responsible, as mentioned previously, for devising strategies through critical analysis and effective problem solving. One of the pitfalls behind the decision-making process in the boardroom is 'groupthink', which is described as a psychological behaviour of minimising conflicts and reaching a consensus decision without critically evaluating alternative ideas in a cohesive in-group environment.

Combining contributions of a group of people with different skills, backgrounds and experiences is assumed to be able to approach problems from a greater range of perspectives, to raise challenging questions and to debate more vigorously within top

management groups. Such a multiple-perspective analysis of problems can change the boardroom dynamics and is more likely to be of higher quality than decisions made under a 'groupthink' environment.

Diversified board members are more likely to possess different personal characteristics, which lead to dissimilar leadership, thinking, emotional styles and even risk preferences and behaviours. Not only may this foster creativity in delivering solutions to problems, but also provide a more comprehensive oversight to the operations of the organisation through a further enhancement of the company's sensitivity to a wider range of possible risks such as reputation and compliance risks. This may then support a greater supervision on the boards in its performance evaluation and in the decision-making process.

Further, companies are competing in a global environment nowadays. In order to achieve organisational goals and objectives, directors need to understand diverse stakeholders' claims – in particular the needs of customers – well. A balanced board will have more representatives of users and customers of its products in the boardroom to make informed judgment. This may be especially important for consumer-facing industries to have female directors and for multinational companies to include foreign nationals on the board.

Dissimilar backgrounds, experience and social networks in the boardroom may therefore improve their understanding of the stakeholders, provide diverse connections with the external environment and help address stakeholders' claims in a more responsive manner.

2. Better utilisation of talent pool

Stakeholders are demanding more from directors, in particular from non-executive directors (NEDs). Having NEDs on the board has already been a common requirement across countries. NEDs are, however, often criticised for having insufficient devotion of time and effort in understanding the business and representing stakeholders to scrutinise executive directors in making appropriate decisions.

One of the problems of searching for suitable directors lies on the limited number of candidates – there is especially a tendency to search for board members with typical characteristics, such as male directors. If directors expand the pool of potential candidates by considering more diversified attributes, like women and ethnic minorities to be included in the boardroom, it will alleviate the problem of 'director shortage' and therefore better

utilise the talent pool. It is therefore vital for companies to initiate tapping into the under-utilised pool of talent through board diversity.

3. Enhancement of reputation and investor relations by establishing the company as a responsible corporate citizen

Having a heterogeneous board can enhance corporate reputation through signalling positively to the internal and external stakeholders that the organisation emphasises diverse constituencies and does not discriminate against minorities in climbing the corporate ladder. This may somehow indicate an equal opportunity of employment and the management's eagerness in positioning the organisation as a socially responsible citizen.

It is also argued that board diversity reflects the diversity of the society and community served by the organisation. This reflection strengthens the social contract between a business and its stakeholders, which, in turn, improves its strategic fit that the business has with its environment. As a result, it is suggested that a diverse board can help a company build its reputation as a responsible corporate citizen that understands its community and deserves its trust.

Further, more institutional investors have taken into account board diversity as a factor for investment evaluation due to the reasons that: (i) a number of academic research papers indicated the positive correlation between firm value and board diversity; and (ii) institutional investors are placing greater emphasis on corporate social responsibility. Board diversity can, therefore, to a certain extent, improve its investor relations.

Costs of diversifying the board

Diversifying the board is not without costs. Though a board is inherently subject to conflict as it is formed by individuals collectively, having a diverse board may potentially increase friction between members, especially when new directors with different backgrounds are stereotyped by existing members as atypical. This may split the board into subgroups, which reduces group cohesiveness and impairs trust among members, leading to reluctance to share information within the board.

Another danger of board diversity is sometimes referred to as tokenism. Theoretically, as

mentioned in the previous section, the minorities in the boardroom are said to contribute to value creation of the organisation by their unique skills and experiences; however, in practice, they may feel that their presence is only to make up the numbers required by the external stakeholders. They may then tend to undervalue their own skills, achievements and experiences, which demeans their potential contribution to the organisation.

Further, the board may potentially ignore the underlying important attributes of successful directors as a sacrifice to meet the requirement of board diversity. The board needs to pay special attention to these costs when implementing measures to diversify the board.

Regulatory initiatives of board diversity

Board diversity can be promoted by a number of methods. Measures currently adopted by different regulatory bodies are generally classified into the following approaches: (i) through imposing quotas on the board; and (ii) enhancing disclosures using the 'comply or explain' approach.

Imposing quotas refers to mandatory requirement in appointing a minimum number of directors with different attributes on the board. This legislation enactment mainly deals with gender diversity to tackle the relative underrepresentation of women in the boardroom. For example, since 2008, each listed company in Norway has had to ensure that women fill at least 40% of directorship positions. Spain and France are implementing similar mandatory requirements for gender diversity. This approach increases the number of women on the board at a faster rate and forces companies to follow the legislation.

Another measure to enhance board diversity is through transparency and disclosure. Companies, under corporate governance codes, are required to disclose their diversity policy in appointing directors so that investors and stakeholders can make proper evaluation. Those who fail to implement such measures have to explain their non-compliance in the corporate governance report or equivalent. The Corporate Governance Code (2010) of the United Kingdom, for example, stipulates that companies are required to: (i) incorporate diversity as a consideration in making board appointments; and (ii) disclose in their annual reports describing the board's policy on diversity, as well as its progress in achieving the objectives of that policy. Australia and Hong Kong are promoting diversity using a similar 'comply or explain' approach. Supporters of this approach believe that board appointments should be made on the basis of business needs, skills and ability instead of legislative requirements, which may sometimes be considered excessive in the market.

Conclusion

Board diversity is justified as a key to better corporate governance. The following extract from academic literature by Conger and Lawler (2001) serves as a good summary of board diversity:

'The best boards are composed of individuals with different skills, knowledge, information, power, and time to contribute. Given the diversity of expertise, information, and availability that is needed to understand and govern today's complex businesses, it is unrealistic to expect an individual director to be knowledgeable and informed about all phases of business. It is also unrealistic to expect individual directors to be available at all times and to influence all decisions. Thus, in staffing most boards, it is best to think of individuals contributing different pieces to the total picture that it takes to create an effective board.'

In implementing policies on board diversity, both the company's chairman and the nomination committee play a significant role.

The chairman, being the leader of the board, has to facilitate new members joining the team and to encourage open discussions and exchanges of information during formal and informal meetings. To create such a well-functioning team, the chairman further needs to commit and support mentoring, networking and adequate training to board members.

The nomination committee should give consideration to diversity and establish a formal recruitment policy concerning the diversity of board members with reference to the competencies required for the board, its business nature as well as its strategies. The committee members have to carefully analyse what the board lacks in skills and expertise and advertise board positions periodically. They are strongly encouraged not to seek candidates merely through personal contacts and networks in order to carry out a formal and transparent nomination process.

The most important ingredient to the success of board diversity, however, would most probably be the board members' changing their mindset to welcome a more heterogeneous board, as well as to place greater trust in one another and work together more effectively.

References

- The Tyson Report on the Recruitment and Development of Non-Executive Directors, June 2003

- Green Paper – The EU Corporate Governance Framework, 2011
- Women on Boards by Lord Davies, February 2011

**Adapted from an article originally written for P1 by Eric YW Leung FCCA, lecturer,
CUHK Business School, The Chinese University of Hong Kong**

Chapter 8 Independence as a concept in corporate governance

Executive Summary

The article explores the theory of independence, and discusses why it is vital in many contexts relating to corporate governance and professional behaviour.

Introduction

The concept of independence occurs at several points in the Strategic Business Leader (SBL) *Study Guide*. It is listed as one of the key underpinnings of corporate governance in Section B5, it is a crucial quality possessed by both internal and external auditors (Sections F2), and it is included in Section A3 as an ethical quality.

In corporate governance, independence is therefore important in a number of contexts. It is vital that external auditors are independent of their clients, that internal auditors are independent of the colleagues they are auditing, and that non-executive directors have a degree of independence from their executive colleagues on a board. But what do we mean by 'independence' as a concept?

Independence is a quality that can be possessed by individuals and is an essential component of professionalism and professional behaviour. It refers to the avoidance of being unduly influenced by a vested interest and to being free from any constraints that would prevent a correct course of action being taken. It is an ability to 'stand apart' from inappropriate influences and to be free of managerial capture, to be able to make the correct and uncontaminated decision on a given issue.

If, for example, an auditor is a longstanding friend of a client, the auditor may not be sufficiently independent of the client. Given that it is an auditor's job to act on behalf of shareholders and not the client, the friendship with the client may compromise the auditor's ability to effectively represent the interests of the shareholders. The auditor may not be as thorough as he ought to be, or he may be influenced to give the benefit of a doubt to the client when he should not be doing so.

The same could apply to non-executive directors (NEDs). In some countries, NEDs are referred to as independent directors to emphasise this very point. NEDs are appointed by shareholders in order to represent their interests on company boards. The primary fiduciary duty that NEDs owe is, therefore, to the company's shareholders. This means that they mustn't allow themselves to be captured or unduly influenced by the vested interests of other members of the company such as executive directors, trade unions or middle management.

Degrees of independence

A common problem in many organisational situations is ensuring independence where it could represent an ethical threat if absent. In real-life situations, friendships and networks build up over many years in which relationships exist at a number of different levels of intensity. Audit engagement partners can get to know clients very well over many years, for example, and serving together on boards can cement friendships between NEDs and executive members of a board.

Clearly then, there are varying degrees of independence. I find the use of continua helpful when describing a variable such as this. A continuum is a theoretical construct describing two extremes and a range of possible states between the two extremes. In the case of the continuum in Figure 1, the left-hand extreme describes the 'total independence' extreme. At this point, the parties in the relationship have no connection with each other, may not know the identity of each other and, therefore, have no reason at all to act other than with total dispassionate independence. On the other extreme on the right-hand side – the 'zero independence' end – the two parties are so intimate with each other they are incapable of making a decision without considering the effect of that decision on the other party.



Figure 1

Of course, in real-life situations, the actual degree of independence is likely to be somewhere between the two extremes, but it is clearly desirable in most situations that the real position should be as near to the left of the continuum as possible. Any of the five main ethical threats can undermine or reduce a person's independence (self-interest, self-review, familiarity, advocacy, intimidation).

In some situations, company law or corporate governance codes make provisions to reduce threats to independence. It is often required, for example, to rotate engagement partners every so many years in an audit situation. Independence is also very important for NEDs, however, and it is to this that I now turn.

Independence and non-executive directors

So looking in a bit more detail at the roles of NEDs in particular, what are the specific benefits of NED independence? We have already discussed the fact that the primary fiduciary duty of a NED is to the company's shareholders. In order to increase NED independence, some shareholders prefer to bring new NEDs in from outside the industry in which the company competes. This is because a number of independence-threatening informal networks can build up within an industry over the years as staff move between competitor companies and as they collaborate in industry 'umbrella' bodies from time to time.

There is a debate about the pros and cons of appointing NEDs that have some industry experience compared to appointing NEDs from outside the industry in which the company in question competes. Previous industry involvement brings with it a higher technical knowledge of issues in that industry (which might be important), a network of contacts and an awareness of what the strategic issues are within the industry. While these might be of some benefit to a NED's contribution, the prior industry involvement might also reduce the NED's ability to be objective and uncontaminated by previously held views: in other words, they can make the NED less independent.

Accordingly, it is sometimes easier to demonstrate independence when NEDs are appointed from outside the industry. In addition to the benefits of the 'new broom' effect of bringing a fresh pair of eyes to a given problem, a lack of previous material business relationships will usually mean that a NED will not have any previous alliances or prejudices that will affect his or her independence.

In practice, many companies employ a mix of NEDs, and it is often this blend of talents and areas of expertise that is what makes a non-executive board effective. Technical input can be given by some NEDs, while wider political or regulatory insights might be provided by others. In large and highly visible companies, NEDs able to bring a social or political perspective to board deliberations can be strategically important. They may have retired senior government ministers or former chairmen of other large companies on their boards to give these insights. The fact that such people usually have no previous material business relationship with the company is seen as important in ensuring that they are materially independent.

Measures to increase NED independence

In order to enhance the independence of non-executive directors, a number of provisions are made in company law and in corporate governance codes. The nature of these provisions and their enforceability in law also varies with jurisdiction.

First, it is usually the case that NEDs should have – and have had – no business, financial or other connections with the company during the past few years (again, the period varies by country). This means that, for example, the NED should not have been a shareholder, an auditor, an employee, a supplier or a significant customer.

Second, cross-directorships are usually banned. This is when an executive director of Company A serves as a NED in Company B and, at the same time, an executive director of Company B serves as a NED at Company A. Such a relationship is considered to make the two boards too intimately involved with each other and potentially reduces the quality of the scrutiny that the two NEDs involved in the cross-directorship can bring.

Third, restrictions or total bans on share options for NEDs are often imposed. These are intended to help ensure that NEDs are able to stand slightly apart from the executive board and offer advice and scrutiny that are unhampered by vested interests such as short-termism on the company's share price.

Fourth, NED contracts sometimes allow them to seek confidential external advice (perhaps legal advice) on matters on which they are unhappy, uncomfortable or uncertain. This should be at the company's expense and helps the NED to gain outside, objective advice on the issue he or she is concerned about. Finally, NEDs are usually time-limited appointments (typically three years) and the number of terms that a NED can serve is also often limited, perhaps to two consecutive terms.

In conclusion, then, independence is an essential quality in a number of situations in corporate governance and in professional behaviour. Independence is sometimes enhanced and underpinned by regulation and legislation, but over and above that, it is expected of every professional person and of every professional accountant.

Adapted from an article originally written by a member of the P1 examining team

Chapter 9 Public sector governance

Executive Summary

This topic is covered in section B6 of the Strategic Business Leader syllabus. The purpose of this article is to introduce this topic and give some pointers as to what the important themes are in terms of teaching and learning.

Introduction

Public sector governance is covered in the section B6 of the new SBL syllabus. In this article, and the second part, these themes will be covered in the order that they appear in the *Study Guide*.

a) Describe, compare and contrast public sector, private sector, charitable status and non-governmental (NGO and quasi-NGOs) forms of organisation, including purposes and objectives, performance, ownership and stakeholders (including lobby groups).

What is the 'public sector'?

In what economists call a 'mixed economy', there is a range of organisations. Some are business organisations and exist to make a profit; others are charitable or benevolent in their purpose, and another type is referred to as public sector. Not to be confused with 'public companies' (which describe the public availability of their shares), these are organisations that are, in some way, connected to, or deliver, public goods and services. This means that they help to, in some way, deliver goods and services that cannot be, or should not be, provided by 'for profit' businesses.

In most cases, public sector organisations are operated, at least in part, by the state. A state, not to be confused with a government, is a self-governing, autonomous region, often comprising a population with a common recent or ancient history. A state has four essential 'organs' without which it cannot fully operate: the executive (or government), the legislature, the judiciary and the secretariat (or administration). Because national constitutions vary, it is not possible to give general examples of how these 'work'.

In the UK, by way of example, however, the head of state is the reigning monarch and the head of government is a different person (the prime minister). The head of government leads the executive, and the head of state is largely a ceremonial position, but in other countries, he or she also has a role in government. The legislature formulates and passes statute law, which the judiciary (the system of courts) interprets and enforces along with other non-statute laws called common laws. In a democracy, the legislature is largely

elected and the judiciary is independent of government so that, if necessary, the judiciary can bring a legal case against the government or members of it.

The state's secretariat or administration is by far the largest of the four 'organs' and is responsible for carrying out government policy and administering a large number of state functions. Again, the roles carried out by the secretariat depend upon the country's constitution but these typically include education, health, local authority provision, central government, defence, foreign affairs, state pensions, tax collection and interior issues such as immigration, policing and prisons. For the most part, organisations such as these are funded by revenues from the state (mainly taxes) and they exist to deliver public services that cannot, or – in the opinion of the government – should not be provided by the private sector (the name given to businesses funded by private capital).

In most developed countries and in many developing countries, the public sector is very large. In the most developed countries, the state spends over 40% of the country's domestic product and this figure is over 50% in some cases. In the UK, for example, the public sector accounts for around a quarter of all jobs. Accordingly, then, the public sector is very large and accounts for many different organisations delivering important services and employing, in many cases, thousands or even millions of people.

Agency in the public sector

One of the key concepts in corporate governance in the private sector is agency. This means that the people who manage a business do not own it, and in fact manage the business on behalf of their principals. It is said that management has an agency relationship with the principals in that they have a fiduciary duty to help the principals achieve the outcomes that they (the principals) seek. In a private or public incorporated business organisation, the principals are shareholders and, in most cases, shareholders seek to maximise the long-term value of their shares. This is usually achieved by profitable trading and having strategies in place to enable the company to compete effectively in its competitive environment.

It is slightly different for public sector organisations. Those employed in the public sector work just as hard as those in the private sector and have objectives that are just as clear (but are sometimes conflicting), but the principals are different. Whereas private and public companies have shareholders, public sector organisations carry out their important roles on behalf of those that fund the activity (mainly taxpayers) and those that use the services

(perhaps pupils in a school, patients in a hospital, etc). Funders (ie taxpayers) and service users are sometimes the same people (for instance, taxpayers placing their children in state school) but sometimes they are not, and this can give rise to disagreements on how much is spent and on what particular provisions. Part of the nature of political debate is about how much state funding should be allocated to which public sector organisation and how the money should be spent.

In general, however, public sector organisations emphasise different types of objectives to the private sector. Whereas private companies tend to seek to optimise their competitive positions, public sector organisations tend to be concerned with social purposes and delivering their services efficiently, effectively and with good value for money.

A common way of understanding the general objectives of public sector organisations is the three Es: *economy*, *efficiency* and *effectiveness*.

- Economy represents value for money and delivering the required service on budget, on time and within other resource constraints. It is common for public sector employees and their representatives to complain about underfunding but they have to deliver value to the taxpayers, as well as those working in them and those using the service.
- Efficiency is concerned with getting an acceptable return on the money and resources invested in a service. Efficiency is defined as work output divided by work input and it is all about getting as much out as possible from the amount put into a system. It follows that an efficient organisation delivers more for a given level of resource input than an inefficient one.
- Effectiveness describes the extent to which the organisation delivers what it is intended to deliver.

Forms of organisation

The entry in the *Study Guide* contrasts 'public sector, private sector, charitable status and non-governmental (NGO and quasi-NGOs) forms of organisation'. The term 'third sector' is sometimes used to refer to charitable and non-governmental organisations. The public and private sector are the first and second sectors, though the order of these – which is the first and which is the second – varies with who is writing. The third sector comprises organisations that do not exist primarily to make a profit nor to deliver a service on behalf of

the state. Rather, they exist primarily to provide a set of benefits that cannot easily be provided by either profit-making businesses or the public sector.

Organisations delivering international medical aid are a good example of non-governmental organisations (NGOs). Well-known NGOs such as *Médecins sans Frontières* ('doctors without borders' in English) are large and well-structured organisations, delivering important medical aid in war zones and the like. Although supported by businesses and governments in their aims and activities, such NGOs are often mainly privately funded (eg by benevolent individuals) and do not operate under either a conventional business or public sector structure.

In such cases, NGOs and charities may have an executive and non-executive board, but these are subject to a higher board of trustees whose role it is to ensure that the NGO or charity operates in line with its stated purpose or terms of reference. In these cases, the agency relationship is between the NGO or charity, and its donors. When donors give to NGOs or charities, it is important for them to be reassured that their donation will be responsibly used for its intended purpose and the board of trustees help to ensure that this is what happens.

In some cases, NGOs can be funded by a government but remain semi-independent of the government in their activities. It might be, for example, that a government is seeking to provide a certain service (eg regional support of businesses) but wants to ensure, because of the importance of that service, that its delivery is free from – and seen to be free from – any political interference. If a government wants to be free from the accusation, for example, that a local business-support decision was based on political advantage for the governing party, it might give a publicly funded organisation effective autonomy in its decision making, even though it is helping to implement government policy.

These organisations are sometimes referred to as QuANGOs – quasi-autonomous non-governmental organisations. QuANGOs are sometimes accused of being unaccountable for their decisions because they only weakly report to the government (and the taxpayers) who fund their decisions. But that is partly the point of a QuANGO: it accounts to many principals including local stakeholders, central government and national taxpayers. QuANGOs can be politically awkward and, accordingly, their use in the public sector changes over time.

Public sector organisations themselves can take several forms. In each case, they are directly responsible for delivering part of a government's policy and are, in most countries,

under the control of the government. This means that they are under 'political control' in that people in government with a political agenda partly control their objectives and activities. In many countries, politics divides along a 'left-right' split while, in others, political divisions are more concerned with ethnicity, culture or religion. In some countries, for example, universities are funded mainly by governments, while, in others, they are mainly private institutions. It is similar with healthcare and schools – in some countries, these are under central government control and funding while, in others, they are privately funded and citizens must pay for services directly or through insurance.

Lobbying and lobby groups

In a democratic society, one in which political priorities are publicly debated and governments change with the collective will of voters, a range of external interests seek to influence public policy. In some cases, external interests coalesce around a certain opinion and it seems appropriate, to some, to campaign to influence government policy in favour of their particular vested interest. When organised specifically to attempt to influence government policy or the drafting of legislation (statute law), such interests sometimes 'lobby' politicians to try to get them to vote in the legislature in favour of their particular interest. These 'lobby groups' may attempt to influence in favour or against a wide range of issues and, although their activities are legal, some argue that they are not always helpful because it is thought by some that those that are the best funded will be the most likely to be heard. This can act against the public interest and in favour of sectional interests and this is thought to not always be helpful to the democratic process.

Stakeholders in the public sector

SBL exams will examine the complexities of stakeholders for a private sector (ie business) as well as public sector organisations as business leaders are required in all sectors. Public sector organisations have, in many cases, an even more complex set of stakeholder relationships than some private sector businesses. Because most public sector activities are funded through taxation, public sector bodies have a complicated model of how they add value. For a private business, revenues all come from customers who have willingly engaged with the business and gained some utility for themselves in the form of benefit from goods or services.

With a government, however, taxation is mandatory and may be paid against the wishes of the taxpayer. Citizens of a country might disagree with the levels of taxation taken by a government, especially when a taxpayer sees most of his or her tax being spent on causes or services that mainly benefit others (and not themselves) and with which they may disagree.

Political theorists have long discussed the importance of a social contract between the government and the governed. In this arrangement, those who pay for and those who use public services must all feel that they are being fairly treated and not being over-exploited nor badly served. Because there are so many claims to balance, then, the stakeholder pressures on a government are often very difficult to understand.

Furthermore, the claims of some stakeholders are assessed differently by different people according to their particular political stance. This means that some stakeholder claims are recognised by some but not by others, and this can make for a very complex situation indeed when it comes to deciding which stakeholder claims to recognise and which to reduce in weight or ignore. Some stakeholders have a very weak voice, while others have no effective voice at all in order to express their claim. Part of the debate in politics is the extent to which these weaker stakeholders are represented and how their assumed needs are met.

Adapted from an article originally written by a member of the P1 examining team

Chapter 10 The strategic planning process Part 1

Executive Summary

These articles (Part 1 & 2) focus on applying your knowledge of management and strategy to a scenario situation. Part 1 considers the complexities of strategic planning and how they can be broken down into three main areas.

Introduction

One of the main problems which Strategic Business Leader (SBL) candidates could face will be the application of knowledge. Candidates might feel comfortable whilst preparing the topics.. The main skill that a student needs to develop is an ability to apply the acquired knowledge in a scenario situation. The following provides an insight into how to apply your knowledge effectively.

This first article deals with the strategic planning process. Many of the various texts on the market comprehensively cover the key processes involved in strategic planning. These often involve comprehensive flow charts with many subparts. Rather than explain these in detail, let us first distil the process into three main areas:

1. Strategic analysis
2. Strategic choice
3. Strategic implementation

Strategic analysis

Essentially a business will address the following questions:

- Where do we want to go?
- What constraints exist on our resources?
- What are the key threats from the external environment?

Where do we want to go?

The answer to this question is influenced by many factors. Key influencers are often the owners (for example, shareholders) who may have a particular expectation for the organisation. However, one also needs to take into account other stakeholder influences, which could include the government, employees and the general underlying culture of the organisation. These views are very often consolidated into a corporate vision or mission statement.

What constraints exist on our resources?

Resources needed would include finance, plant and machinery and human resources. However, to make it easy, I would recommend that you simply think 6Ms. 6Ms is simply a mnemonic used to save time when thinking about the various resource constraints. It can be summarised as:

- money
- machinery
- manpower
- markets
- materials
- make-up.

The typical questions, which you would ask against each of these resource constraints, would be as follows:

Money

- How much do we have?
- What is the current cost of our capital?
- Is the company excessively geared or are there any opportunities for raising additional finance?

Machinery

This would refer to machinery in the broadest sense of the word, and typical questions one might ask would include:

- How technically up to date is the machinery?
- Is there a danger of obsolescence?
- Has it been poorly maintained over the years?

Manpower

- How expensive is our workforce?
- How efficient are our employees?
- Is the business overstaffed?
- Is it understaffed?
- What is the labour turnover rate?
- What is the absence rate?

- Are there good structures to allow management succession?

Markets

There is a danger of overlapping with the external environment here, so try to keep to such questions as:

- Are the markets declining/growing?
- Where are new markets emerging?
- How strong are our brands in the current market?

Materials

- How expensive are our materials compared to our competitors?
- Do our suppliers have excessive control of materials?
- Do we have favourable access to materials?
- Are our raw materials becoming exhausted?

Make-up

- What type of structures do we have and are they likely to limit future growth?
- What is the culture of the organisation and will it stifle or fuel future developments?

We will explain later how we can apply these concepts to a case scenario.

What are the key threats from the external environment?

Once we have established constraints on our internal resources we need to assess the threat posed by the external environment. The easiest way to assess the external environment is to use the following two frameworks:

1. Porter's five forces.
2. PESTEL analysis.

Porter's five forces

The American management writer Michael Porter describes the main external competitive threats to be summarised by his five forces model. Essentially, this model determines the

level of competition an organisation is facing by assessing the extent to which the five forces are relevant. The five forces are summarised as follows:

1. The threat from new entrants.
2. The bargaining power of buyers.
3. The bargaining power of suppliers.
4. The threat from substitute products.
5. The extent of competitive rivalry.

1. The threat from new entrants

This is a problem because if competitors can easily enter your business sector they will be able to put a ceiling on your profits. Therefore, the greater the threat from new entrants entering the sector, the higher the levels of competition. The ease which new entrants can enter the business segment is largely determined by the extent of the barriers to entry.

The following summarises the main barriers to entry.

- *Capital cost of entry.* The higher the capital cost, the greater the deterrent to someone entering the business and, therefore, the likelihood of competition being less than in industries where it is much cheaper to set up business.
- *Economies of scale.* This will apply if a substantial investment is needed to allow a new entrant to achieve cost parity. Therefore, anyone entering the segment that cannot match the economies of scale will be at a substantial cost disadvantage from the start.
- *Differentiation.* Differentiation is said to occur if consumers perceive a product or service to have properties, which make it unique or distinct from its rivals. The differentiation can be in the appearance of the product, its brand name or services attached to the product – for example, Concorde. Therefore, if new entrants are to be successful in entering the market they will need to spend a lot of money on developing the image of the product – hence, they are likely to be put off.
- *Switching costs.* This is the cost not incurred by a new company wishing to enter the market but by the existing customers. If the buyer will incur expense by changing to a new supplier, they may not wish to change. For example, when the compact disc was invented consumers had to incur a cost of a CD player, as the new compact discs would not work on a conventional record player.
- *Expected retaliation.* If a competitor entering a market believes that the reaction of an existing firm will be too great then they will not enter the market.
- *Legislation.* There might be patent protection for a product or the government might only license certain companies to operate in certain segments – for example, Nuclear Power.
- *Access to distribution channels.* Existing relationships between manufacturers and the key distributors of the products may make it difficult for anyone else to enter the market.

Therefore, in summary, when thinking about the barriers to entry go through the above list in your planning to see which of them apply. Remember that it is unlikely that they all will apply, but the checklist should ensure that all those that do apply would be picked up.

2. The bargaining power of buyers

Do the buyers of the product have the power to depress the supplier's prices? If the answer to this question is yes, it is likely that competition will increase. Buyers will have power when:

- they are concentrated and can exert pressure on the supplier
- the buyer has a choice of alternative sources of supply.

3. The bargaining power of suppliers

The extent of supplier bargaining power is very closely linked in with the issues of buyer power. The extent of the power of the suppliers will be affected by:

- the concentration of suppliers: if only a few suppliers, the buyers will have less opportunity to shop around
- the degree to which products can be substituted by the various suppliers
- the level of importance attached to the buyer by the supplier. The switching costs of moving to another supplier.

4. The threat from substitute products

If there are similar products that can be used as substitute then the demand for the product will increase or decrease as it moves upwards or downwards in price relative to substitutes.

5. The extent of competitive rivalry

The most competitive markets will be affected by the previously discussed forces. However they will also be affected by:

- the number of competitors and the degree of concentration
- the rate of growth of the industry
- the cost structures if high – fixed costs prices are often cut to generate volume
- the exit costs. If they are high, firms may be willing to accept low margins so as to stay in the industry.

PESTEL factors

The other framework, which should be applied when surveying the external environment, is PESTEL factors:

- Political
- Economic
- Social
- Technological
- Environmental
- Legal.

Again, all of these factors will not necessarily apply but provide a useful checklist against which you can compare in an exam situation. They are explained more fully below.

Political environment

The organisation must react to the attitude of the political party that is in power at the time. The government is the nation's largest supplier, employer, customer and investor and any change in government spending priorities can have a significant impact on a business – for example, the defence industry.

Political influence will include legislation on trading, pricing, dividends, tax, employment, as well as health and safety.

Economic environment

The current state of the economy can affect how a company performs. The rate of growth in the economy is a measure of the overall change in demand for goods and services. Other economic influences include the following:

1. Taxation levels.
2. Inflation rate.
3. The balance of trade and exchange rates.
4. The level of unemployment.
5. Interest rates and availability of credit.
6. Government subsidies.

One should also look at international economic issues, which could include the following:

1. The extent of protectionist measures.
2. Comparative rates of growth, inflation, wages and taxation.

3. The freedom of capital movement.
4. Economic agreements.
5. Relative exchange rates.

The social environment

The organisation is also influenced by changes in the nature, habits and attitudes of society.

- Changing values and lifestyles.
- Changing values and beliefs.
- Changing patterns of work and leisure.
- Demographic changes.
- Changing mix in the ethnic and religious background of the population.

The technological influences

This is an area in which change takes place very rapidly and the organisations need to be constantly aware of what is going on. Technological change can influence the following:

- Changes in production techniques.
- The type of products that are made and sold.
- How services are provided.
- How we identify markets.

Environmental

This concerns issues regarding factors that could impact on the ecological balance of the environment and could include such issues as climate change and pollution

Legal environment

How an organisation does business:

- Law of contract, law on unfair selling practices, health and safety legislation.
- How an organisation treats its employees, employment laws.
- How an organisation gives information about its performance.
- Legislation on competitive behaviour.
- Environmental legislation.

Therefore, when surveying the external environment think through Porter's five forces and PESTEL factors and you will have a fully comprehensive framework with which you can assess the case.

The example below relates to a P3 exam syllabus, which is also relevant to the new SBL syllabus

Championsoft is a specialist software house, which has developed and now markets a modular suite of financial software packages under the product name of Champlan. In addition, the company provides a systems design consultancy service to the financial services industry. The company was established in 1988 and the three founding shareholders are also the three full-time working directors. Extracts from the financial results for the last three years are given below. These show declining profitability although aggregate sales revenue has increased year on year.

| Year | Champlan units sold | Champlan sales \$ | Systes design services sales \$ | Operating profits \$ |
|------|---------------------|----------------------|------------------------------------|-------------------------|
| 2010 | 2,050 | 922,500 | 650,000 | 162,000 |
| 2011 | 2,700 | 1,080,000 | 600,000 | 144,000 |
| 2012 | 3,600 | 1,260,000 | 550,000 | 107,500 |

Operating profit is before interest charges and taxation. The current interest rate on the medium term loan is 10% per annum.

Got it Pass eLearning Co**Supplementary Notes**

| Year | Fixed assets \$ | Current assets \$ | Current liabilities \$ | Medium term loan \$ | Share capital and reserves \$ |
|------|-----------------------|-------------------------|------------------------------|---------------------------|-------------------------------------|
| 2010 | 950,000 | 425,000 | 260,000 | 200,000 | 915,000 |
| 2011 | 1,000,000 | 525,000 | 375,000 | 200,000 | 950,000 |
| 2012 | 1,225,000 | 650,000 | 475,000 | 400,000 | 1,000,000 |

The current liabilities figure includes an overdraft with the bank of £300,000. This is also the agreed maximum. The company owns its own premises and these comprise the majority of fixed assets. The premises have recently been expanded to cope with the increased sales volume of the Champlan package. Although the consultancy workload of the company has shown some decline in recent years, this has been due to pressure on the software staff to develop more powerful versions of the Champlan package rather than a shortage of potential work. Championsoft is well regarded in the system design services field and attracts good profit margins on the work carried out. It is estimated that the operating profit to sales ratio on system design services is in the region of 15%.

Championsoft employs 18 people mainly as software specialists. There is little subcontract software development undertaken. The managing director and majority shareholder with 40% of the voting capital is Simon Champion. He was the prime mover behind the creation of Championsoft and has substantial experience in the financial services industry. He sees his main role as ensuring the efficient day-to-day administration of the business. The software technical aspects of the business are managed by the technical director, Dr John Chan, who holds 30% of the voting share capital. He is responsible for research and

development on the Champlan product range, customer technical support on software products and systems design consultancy projects.

Jill Mortimer, the third director, holds the final 30% of voting shares and is in charge of sales and marketing of both software products and consultancy services. Her background is in the marketing of fast moving consumer products.

Championsoft see its Champlan product range as a market leader in terms of quality and functionality, although this segment of the software market appears to be increasingly driven by price and product awareness. There is also a recent marked tendency for hardware suppliers to bundle in the Champlan product as part of the hardware price of their product. The main competitor to Champlan is the Pennsoft product range. Pennsoft is part of a large international organisation, and its product range is very similar to Champlan if lacking in its level of functionality. Pennsoft software is marketed at prices, which have always undercut Champlan. Jill Mortimer believes that Pennsoft hold about two-thirds of the market, Champlan about one-quarter and the rest is split among a few other software houses. There are few barriers to other software houses entering this market. Almost any quality software house is able to produce a similar product for this market providing that they are willing to devote sufficient resources.

Jill Mortimer has a strong personality and her views have tended to dominate the recent direction of the business. She believes that Championsoft must cut its prices and put more effort into winning sales. 'Look at the way the software market is developing. Every year there is a bigger market as new users get access to the hardware. Our extra sales effort and a bigger sales force will easily be covered by additional unit sales. We must tackle Pennsoft head on and capture some of their market share.' Last year Championsoft spent £100,000 on advertising while Pennsoft spent in the region of £500,000.

Simon Champion is not fully convinced. 'Although our current advertising has generated lots of enquiries, very few of these resulted in firm sales. In fact, the high level of spending on promotion is straining our cash flow.' He was thinking about the letter recently received from the bank which, while professing continuing support, pointed out that Championsoft's overdraft was rising year on year and that this must not be seen as a permanent source of finance. The bank had concluded that it would like to see some medium-term projection about how the overdraft was to be brought under control.

As usual John Chan took the opportunity to launch into his familiar attack on the marketing strategy or lack of strategy as he was heard to remark to his software team: 'We should

move away from the package market and into consultancy activities. These build on our reputation and software expertise.

'The margins are good and we can sell on recommendation not expensive advertising campaigns. As it stands, my team is being torn between development of Champlan and working on software projects. We cannot do both well, we are in danger of losing clients and at the same time failing to keep the edge over Pennsoft.'

Simon Champion was at a loss how to respond. Something had to be done, but what?

Simon Champion has come to see you, as the company's auditor, and has asked for your objective advice. He feels that Championsoft needs a strategy but is not sure what it should be or how to go about preparing it. 'Events move so fast in our industry that plans are out of date before they can be implemented' was a comment made at your meeting.

Requirements

(a) Identify any additional internal and external information, which you need before you could set about writing your report and indicate how you would gather such information. (12 marks)

Suggested approach

As you can see, the question asked above in the case scenario clearly seeks for information of both an internal and external nature together with how you would gather such information.

All answers in the exam should be roughly planned out and all you need to remember to score well in this part of the question are the mnemonics to help you break down the internal and external factors.

So, to help get some structure for internal factors, think 6Ms and you think:

- Money
- Markets
- Machinery
- Materials
- Manpower
- Make-up

We then need to quickly think which of these 6Ms would be most relevant to the answer. I would expect your thought process to go something like the following:

- Machinery? Is machinery relevant to Championsoft's business as a specialist software house? How cost effective is the current use of the machinery? You may comment on the fact that in order to remain competitive ongoing investment in the latest equipment is likely to be relevant.
- Money? An analysis of profitability of individual products, how competitive is the interest on the medium-term loan?
- Manpower? Cost/productivity/staff turnover of the current employees compared to the industry average.
- Markets? The growth potential for financial software and the systems design consultancy market.
- Materials? In the case of Championsoft, materials do not seem to be so relevant so I would suggest no comment is needed.
- Make-up? We would need to look at the current culture of the staff and assess whether it would be happy if one side of the business was run down – for example, software development.

Therefore, we have shown how, by using the 6M's approach in our plan, we can provide ourselves with more than enough criteria on which to comment. We should now be confident in applying five forces and PESTEL in much the same way – for example, questions regarding the five forces would include:

- What are the main barriers to entry for new entrants entering the software and design consultancy business and how much of a deterrent are they?
- Do buyers have the power to ask Championsoft to reduce its prices? You may comment on the fact that it has an alternative choice in Pennsoft and therefore may be able to get a more competitive price than if Pennsoft was not there.
- Are there any other packages out in the market that could be used as a substitute for Championsoft's products?
- Questions of a PESTEL nature would be similar to those used above.

Armed with this information in your plan you should now be able to develop an answer that should fulfil the 12 marks allocated. Do not forget to answer the entire question, which required suggestions as to how you would gather such information suggested. It must be stressed that all of the 6Ms, five forces and PESTEL need not necessarily be used in your answer, but they should almost certainly be used in developing your answer plan.

P3 past exam-related example, which is also relevant to the SBL syllabus

Bowland Carpets Ltd

An example of a question that concentrates on a specific part of the above environmental analysis is given below.

Bowland Carpets Ltd is a major producer of carpets within the UK. The company was taken over by its present parent company, Universal Carpet Inc, in 2012. Universal Carpet is a giant, vertically integrated carpet manufacturing and retailing business, based within the US but with interests all over the world.

Bowland Carpets operates within the UK in various market segments, including the high value contract and industrial carpeting area – hotels and office blocks, etc – and in the domestic (household) market. Within the latter the choice is reasonably wide, ranging from luxury carpets down to the cheaper products. Industrial and contract carpets contribute 25% of Bowland Carpets' total annual turnover, which is currently £80m. During the late 1980s the turnover of the company was growing at 8% per annum, but since 2011 sales have dropped by 5% per annum in real terms. Bowland Carpets has traditionally been known as a producer of high quality carpets, but at competitive prices. It has a powerful brand name, and it has been able to protect this by producing the cheaper, lower quality products under a secondary brand name. It has also maintained a good relationship with the many carpet distributors throughout the UK, particularly the mainstream retail organisations.

The recent decline in carpet sales, partly recession-induced, has worried the US parent company. It has recognised that the increasing concentration within the European carpet-manufacturing sector has led to aggressive competition within a low growth industry. It does not believe that overseas sales growth by Bowland Carpets is an attractive proposition, as this would compete with other Universal Carpet companies. It does, however, consider that vertical integration into retailing (as already practised within the US) is a serious option. This would give the UK company increased control over its sales and reduce its exposure to competition. The president of the parent company has asked Jeremy Smiles, managing director of Bowland Carpets, to address this issue and provide guidance to the US board of directors. Funding does not appear to be a major issue at this time as the parent company has large cash reserves on its balance sheet.

Requirements

Acting in the capacity of Jeremy Smiles you are required to outline the various issues, which might be of significance for the management of the parent company. Your answer should cover the following:

- (a) To what extent do the distinctive competencies of Bowland Carpets conform with the

key success factors required for the proposed strategy change? (10 marks)

(b) Suggest and discuss what might be the prime entry barriers prevalent in the carpet retailing sector. (7 marks)

(c) In an external environmental analysis concerning the proposed strategy shift, what are likely to be the key external influences that could impact upon the Bowland Carpets decision? (8 marks)

(Total: 25 marks)

Suggested approach

If we are to concentrate on Part (b), you can see that it asks for the prime entry barriers in the carpet retailing sector. All that you need to do here is undertake a quick brainstorm of what we described earlier as barriers to entry and then see whether any of them will apply to the carpet retailing sector.

So thinking back the main barriers to entry which we listed were:

- Capital cost of entry
- Economies of scale
- Differentiation
- Switching costs
- Expected retaliation
- Legislation
- Access to distribution channels

Most of the above could be a potential barrier in the carpet retailing sector, but in order to score high marks you need to apply them in the context of carpet retailing rather than just list them.

- *Capital cost of entry.* How much investment would be required in a lease and stock?
- *Economies of scale.* Are there any current carpet retailers that have superior buying power and economies of scale in distribution and marketing?
- *Differentiation.* Are there any retailers that have high levels of customer loyalty to their shop, which would prevent them from buying carpets from anyone else?
- *Switching costs.* Switching costs are not relevant and one would become relevant if a householder were to enter into a lifelong contractual agreement to buy all their carpets from one particular retailer, which is clearly unlikely.
- *Expected retaliation.* If a retailer existed in the carpet retailing sector that was very aggressive to any potential new competitor this could prove to be a potential barrier.

- *Legislation.* Are there any planning constraints or specific licences that are needed to operate in the carpet retailing sector.
- *Access to distribution channels.* How easy will it be for a new entrant in the carpet retailing sector to find a prime retailing site that is appropriate for the sale of carpets.

Therefore, using the framework in an applied way, we have been able to construct an answer that, if presented appropriately, will be worth almost maximum marks. If you look at Part (c) you will see that the external analysis frameworks fit in perfectly again – see if you can do it.

Summary

Hopefully now when we think about the strategic planning process we think about:

1. Strategic analysis.
2. Strategic choice.
3. Strategic implementation. This article has explained in detail the process of strategic analysis, which we should all be able to break down into:
 - Where do we want to go?
 - What constraints exist on our resources? (6Ms)
 - What are the key threats from the external environment? (five forces, PESTEL)

The next article will take a similar approach to the issues of strategic choice and implementation.

Adapted from an article originally written by Sean Purcell BA ACMA (a leading freelance lecturer for P3 and lectures on the ACCA Study School and Train the Trainer Programme for P3 and SBL)

Chapter 11 The strategic planning process Part 2

Executive Summary

These articles (Part 1 & 2) focus on applying your knowledge of management and strategy to a scenario situation. Part 2 adopts a similar simplification approach to the issues of strategic choice and strategic implementation.

Introduction

Part 1 considered the complexities of strategic planning and how they can be broken down into three main areas. Part 2 adopts a similar simplification approach to the issues of strategic choice and strategic implementation.

Strategic choice

Johnson and Scholes break down the issue of strategic choice into three distinct subheadings, which are:

- On what basis do we decide to compete?
- Which direction should we choose?
- How are we going to achieve the chosen direction?

On what basis do we decide to compete?

A useful framework to use here is Porter's generic strategies. Michael Porter stated that a firm that is wishing to obtain competitive advantage over its rivals is faced with two choices:

Choice 1: Is the company seeking to compete by achieving lower costs than its rivals achieve and by charging similar prices for the products and services that it offers, thereby achieving advantage via superior profitability? Or...

Is the company wishing to differentiate itself and the customer is prepared to pay a premium price for the added value which the customer perceives in the product, and thereby enjoys greater margin than the undifferentiated product.

Choice 2: What is the scope of the area in which the company wishes to obtain competitive advantage? Is it industry-wide or is it restricted to a specific niche?

The answers to these two choices leave the organisation faced with three generic strategies, which are defined as:

1. cost leadership
2. differentiation
3. focus.

1. Cost leadership

Set out to be the lowest cost producer in an industry. By producing at the lowest possible cost the manufacturer can compete on price with every other producer in the industry and earn the highest unit profits.

In order to achieve cost leadership some of the following need to be in place:

- Seek to set up production facilities for mass production as these will facilitate the economies of scale advantages to be achieved.
- Invest in the latest technology – improved quality less labour needed.
- Seek to obtain favourable access to sources of raw materials.
- Look to develop product designs that facilitate automation.
- Minimise overhead costs by exploiting bargaining power.
- Concentrate on productivity objectives and constantly seek to improve efficiency and economy – for example, ZBB, value chain analysis.

One should also be aware of the drawbacks of such a strategy, such as the need to continually keep up to date with potential changes in technology or consumer tastes.

2. Differentiation

A firm differentiates itself from its competitors when it provides something unique that is valuable to buyers. Differentiation occurs when the differentiated product is able to obtain a price premium in the market that is above the cost incurred to create the differentiation.

As a consequence of differentiation being about uniqueness, it is not really possible to give an exhaustive list detailing how a firm may differentiate itself. To truly differentiate yourself we must understand the product or service offered and the customer to whom you are selling it.

Ways of achieving differentiation:

- **Image differentiation**

Marketing is used to feign differentiation where it otherwise does not exist – ie an image is created for the product. This can also include cosmetic differences to a product that does not enhance its

performance in any serious way – for example, perfume – colour, size, packaging.

- **Support differentiation**

More substantial, but still has no effect on the product itself, is to differentiate on the basis of something that goes alongside the product, some basis of support. This may have to do with selling – for example, 0% finance, 24-hour delivery.

- **Quality differentiation**

This means the features of the product that make it better – not fundamentally different, but just better. The product will perform with:

- greater initial reliability
- greater long-term durability
- superior performance.

- **Design differentiation**

Differentiate on the basis of design and offer the customer something that is truly different as it breaks away from the dominant design if there is one – for example, Apple's iMac computer.

- **Reward of a differentiation strategy**

Consumers are likely to pay a higher price for the goods because of the added value created by the differentiation.

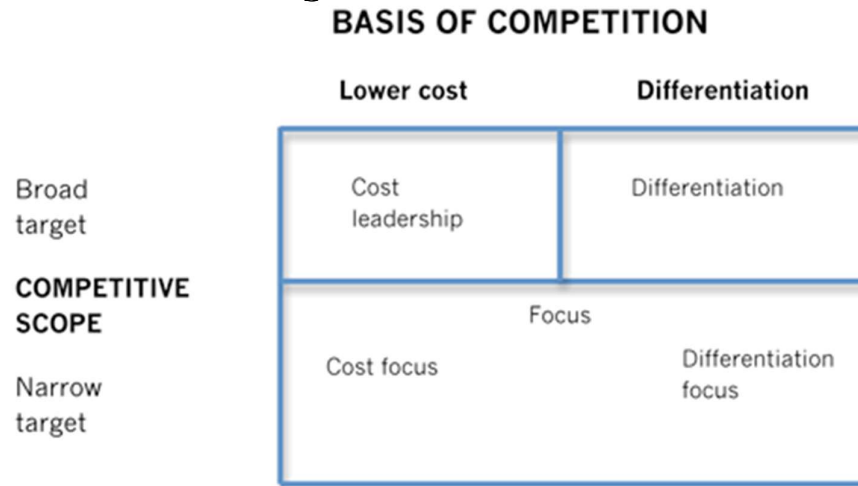
3. Focus

A focus strategy is based on fragmenting the market and focusing on particular market niche. The firm will not market its products industry-wide but will concentrate on a particular type of buyer or geographical area.

Cost focus: This involves selecting a particular niche in the market and focusing on providing products for that niche. By concentrating on a limited range of products or a small geographical area, the costs can be kept low.

Differentiation focus: Select a particular niche and concentrate on competing in that niche on the basis of differentiation – for example, luxury goods.

This can be summarised in the following diagram:



An example of a focus strategy

We stated that the alternative directions available to a business could be described in general terms as follows:

1. Do nothing
2. Withdrawal
3. Market penetration
4. Product development
5. Market development
6. Diversification

Do nothing

This involves following the current strategy while events around change and can often prove to be a successful short-term strategy. Basically, if an organisation is exposed to some form of competitive threat, its short-term objective is to not react and, hence, get involved in what could be an expensive decision.

Sell out/withdraw from the market

This may be followed so as to maximise the return on a business that may be at the top of its cycle and, hence, will be in line with the goal of maximisation of cash flows. Withdrawal from a business sector may be chosen to give the business more focus – for example, Richard Branson's decision to sell his original business Virgin Records to concentrate on the airlines business.

Market penetration

This involves increasing the market share in the current market with the current product. Market share can be enhanced by such techniques as improved quality, productivity or increased marketing activity.

Product development

This involves introducing a new product into the current market. The product change is often the result of changes and modifications to an existing successful product – for example, Mars ice cream. This is an alternative to the present product and builds on present knowledge and skills.

Market development

In this case the organisation keeps its tried and tested products but aims to apply them to different market segments. This strategy maintains the security of the present product while enabling extra revenue to be generated from new segments – for example, McDonald's and its geographic market development.

Diversification

This is the most risky of the product market strategies as it involves the introduction of a totally new product in a new market. Diversification can either be related or unrelated.

Related diversification

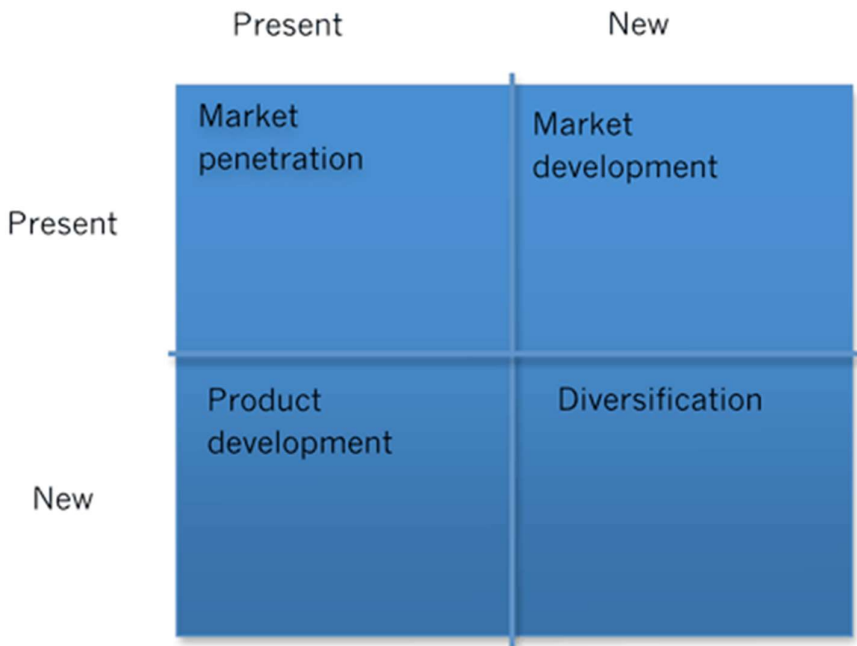
This involves development of the product and market but still remaining within the broad confines of the industry. There are three main types.

1. Backward. A development into the business that inputs into the present business – for example, move up the supply chain into raw material inputs.
2. Forward. A development into activities concerned with a company's outputs also called downstream integration – for example, move down the supply chain into distribution activities.
3. Horizontal. Movement into activities that are competitive with existing activities – for example, to benefit access to market or technology.

Unrelated diversification

This involves movement into industries that bear little relationship to the present one and is often the result of a profit motive.

Ansoff represented the last four choices in his product/market matrix.



Ansoff's product market matrix

How?

The final problem that must be overcome is to decide how the chosen strategic option should be undertaken.

The options available are:

- internal development
- external development/acquisition
- joint development.

Internal development

Reasons

Often undertaken to maintain the present equilibrium within the company as it is much less disruptive than an acquisition. Another reason may be that there is not sufficient finance available for an acquisition or that the government may prevent acquisition/merger through legislation.

Acquisitions

- If there is sufficient finance available an acquisition will provide a very quick way of providing access to new product/market areas and the new organisation will have economies of scale advantages.

Joint development

A formal agreement between two or more organisations to undertake a new venture together – for example, Airbus (spreading of cost).

Methods of joint development

- *Consortia*. Two or more firms working together to share the costs and benefits of a business opportunity.
- *Joint venture*. A separate business entity whose shares are owned by two or more business entities.
- *Strategic alliance*. A long-term agreement to share knowledge, technology or business opportunities.
- *Franchising*. The purchase of the right to exploit a business brand in return for a capital sum and a share of profits or turnover. The franchiser also usually provides marketing and technical support to the purchaser of the franchise.
- *Licensing*. The right to exploit an invention or resource in return for a share of proceeds. Differs from franchise because there will be little central support.

To summarise, we can use Figure 1. Once all the alternative options have been generated we need to evaluate their appropriateness before making a choice. A useful framework to apply when considering the appropriateness of an option is:

- suitability
- feasibility
- acceptability

Suitability

Suitability identifies the extent to which the proposed strategy enhances the situation identified in the strategic analysis. The following questions need to be addressed about the strategic options:

- Does it close the planning gap?
- Does it address threats and weaknesses?
- Does it build on identified strengths and exploit opportunities?
- Does it fit in with the organisation's mission?

- Will the portfolio remain balanced?

Feasibility

The issue of feasibility evaluates whether the chosen strategy can be implemented successfully. The resources the organisation has at its disposal will obviously determine this. To save time, simply think about the 6Ms.

Acceptability

The final issue to address is whether the selected strategy will meet the expectations of the key stakeholders in the firm and typical issues to be looked at would include the level of risk and return resulting from the option.

Remember that in the exam it is unlikely that you are going to get a question that asks you to regurgitate the information on strategic choice in the way in which I have just explained to you. Questions will normally touch on some part of the process we have described and if you have an in-depth understanding of everything that we have covered you will be able to construct much more comprehensive arguments in the exam. We will show this in a previous exam question later.

Strategic implementation

The area of strategic implementation covers many areas from project management to structure. However, as with strategic analysis and strategic choice, it is possible to simplify the issues in to a number of key sub-headings:

- Resource management.
- Organisational structure.
- Management of change.

Resource management

This will ensure that the 6Ms are working for you in the best way possible. Budgets and other performance management tools are likely to be used here.

Organisational structure

This will deal with issues regarding the levels of centralisation and decentralisation, together with structural form and style of management.

Management of change

The scope, speed and style of the changes need to be carefully reviewed in order to obtain full commitment to them. A useful model of change to remember is Kurt Lewins' three-step model, which involved:

- unfreeze
- change
- refreeze.

Unfreeze

For the change to take place the existing equilibrium must be broken down before a new one can be adopted.

Change

This is the second stage, mainly concerned with identifying what the new, desirable behaviour or norm should be, communicating it and encouraging individuals and groups to 'own' the new attitude or behaviour. To be successful, one should consider the adoption of the following management styles to improve the acceptance of the change:

- Participation with employees affected by the change, so that they feel more of a sense of ownership.
- Education and communication of the new ways, so that they fully understand what is going on and are not in a situation where they are afraid of the unknown and therefore show resistance.
- Negotiation may also be appropriate if there are large group stakeholders such as a trade union.

Refreeze

This is the final stage, implying consolidation or reinforcement of the new behaviour. Positive reinforcement (praise, reward, etc) or negative reinforcement (sanctions applied to those who deviate from the new behaviour) may be used. You should also look at the Change Kaleidoscope and Cultural Web.

Therefore to summarise what we have just said:

Strategic choice

- On what basis do we decide to compete? (Porter's generic strategies.)
- Which direction should we choose? (Ansoff's product market matrix, do nothing, withdraw.)
- How are we going to achieve the chosen direction? (Internal external joint venture.)

Strategic implementation

- Resource management (6Ms)
- Organisational structure (centralisation, decentralisation, specific structural form)
- Management of change (unfreeze, change, refreeze)

Let us see how we can expect to get questioned in this area in the exam.

Question 1**Sample ACCA exam**

Jerome Gulsand is the owner and chief executive of a chain of 20 sports equipment shops, Sportak. These shops are clustered in the south of the country. The company is privately owned by the family and the freeholds of these shops, which the company owns and which are on prime retail sites, account for the majority of the assets of Sportak. The company sells a wide range of sports equipment such as golf clubs, tennis, skiing equipment, soccer and other sports equipment. Recently it has expanded its range to include certain types of designer sports clothing.

The company was founded by Jerome's father a quarter of a century earlier when he opened his first small shop. Over the next 25 years the company grew steadily. A major reason for this successful development lay with the philosophy of Jerome's father who delegated much of the decision-making to the individual shop managers. He believed that this gave the local managers a higher degree of motivation. It also allowed them to respond to local demand conditions as stock ordering was carried out by each shop and was not organised at the head office. The managers were also permitted to develop local marketing activities, using sales promotions and publicity as they felt appropriate.

These shop managers were remunerated partly by a basic salary and partly by a sales-related performance bonus, which could be up to 40% of their basic salary. These methods of operation were satisfactory while the company was operating in a steady growth environment. However, by late 2007 there was evidence that Sportak's overall position within the market was weakening. Sales had stabilised but, even more importantly, competition was growing from a number of discount traders who were prepared to operate on low profit margins but with larger volumes. It was at this time that Jerome took over the company from his father.

Jerome was impatient with the lack of growth. By nature he was an entrepreneur who sought growth. He was not sure that the steady organic growth was appropriate to these

conditions. His father's policy had been to open a store each year, funding this growth out of current earnings. Jerome saw that the market was becoming so competitive that even small and specialist markets were proving to be vulnerable. He believed that only the big, nationwide retail chains would survive and that the smaller sized groups would be taken over by the larger chains of sports goods retailers who were more profitable and had greater capability to raise finance.

He decided that a 'dash for growth' was required if the company was to achieve the critical size to survive in the market place. It had been suggested to him that the franchising of the Sportak brand name would be a reasonable and relatively risk-free method of expansion. Growth, using other people's money, has its advantages, but it did not appeal to Jerome. He wanted a more 'hands-on' approach.

At about this time another chain of 15 sports shops became available for purchase. This group was in a distinctly separate area of the country – about 150 miles from Sportak's current area of operations. As the overall sports equipment and sportswear market was still growing, the price being asked for this acquisition was rather high. However, Jerome was convinced that this was too good an opportunity to miss. He believed that Sportak needed this expansion so as to take advantage of the profitable sales still available in this sector. However, for an acquisition of this size, it was obvious that the growth could not be funded internally. Jerome assumed that he might use the freeholds of the properties Sportak owned as securities for the finance the company needed to borrow. Before approaching the bank Jerome discussed this issue with his accountant and offered the following ideas for his proposed expansion.

In anticipating this proposed expansion and the need to manage an enlarged group, Jerome believes that it is time for a strong and centralising leader. Recognising that the current system of product ordering is delegated to individual store managers, he proposes to provide a centralised purchasing function based upon a warehouse owned and controlled by Sportak. Individual shop managers will be permitted to decide upon their stock range, but they will have to order from the central warehouse set up by Sportak.

Jerome has also decided to tackle the problem of marketing and, in particular, promotion. The decentralised approach adopted by his father has not brought about the development of a well-known image and, therefore, the brand of Sportak needs to be strengthened. Under Jerome's plan it is proposed to allocate a substantial budget – 15% of sales – to spend on press advertising and on public relations, and this level of commitment will continue for the foreseeable future. Sports personalities will be paid to appear in all stores,

which will have to be re-equipped. By a competent use of merchandising it is hoped that these stores will increasingly be recognised as centres for influencing the fashion of both sports equipment and clothing. The shop managers will also be encouraged to stock more expensive lines of products where the margins will be higher and, in addition, they will be expected to hold much more stock. A criticism of the stores when Jerome's father was in charge was that they were often short of stock. Most customers were unwilling to wait for the product to be ordered and they therefore bought from competitors' shops.

Jerome recognised that during this period of change Sportak might lose a number of its key shop managers. These people have enjoyed substantial autonomy, and although they will still have some freedom on the stock range that they offer, they might increasingly see their freedom to act as managers being eroded. In appreciating that these shop managers provide much goodwill and their loss would be damaging to the company, Jerome is proposing to increase their sales-related bonuses as an inducement to stay.

Jerome fully understands that the costs incurred in the proposed acquisition involve more than the purchase of the new shops. Store modernisation programmes for all the shops, as well as upgrading stock with a wider and more sophisticated range of products, will also require funding. Forecasts of immediate future sales appear to be attractive. Jerome anticipates that sales per store will rise by about 8% over the next year. He believes that this growth in sales, accompanied by his more aggressive approach to retailing, will enable his bold expansion plans for Sportak to be achieved. Above all, Jerome wishes to see his company, Sportak, become a national company, no longer having to operate as a regional retailer does.

In Table 1 is a summary of the figures that have been prepared by Jerome's accountant for discussion. Part of the data has been obtained from trade association statistics as well as government forecasts.

Requirements

(a) Jerome Gulsand's father was a great believer in the decentralisation of both operations and decision making. To what extent has this process harmed or benefited Sportak?

Provide examples to justify your arguments. (10 marks)

(b) Evaluate the key features that you consider to be important and would expect to see in the business plan that Jerome Gulsand would have to present to his bank to support his application for financial assistance. (15 marks)

(c) Acting in the position of Jerome Gulsand's accountant, and using the financial data provided and the intentions developed by Jerome, assess the viability of the strategy that

has been proposed by him. (15 marks)

(d) Discuss whether a franchise operation would have been a better option for expansion than an acquisition. (10 marks)

Table 1

| | 2007 Actual \$m | 2008 Budget \$m | 2009 Forecast \$m | 2010 Forecast \$m |
|------------------|-----------------------|-----------------------|-------------------------|-------------------------|
| Sales of revenue | 30.00 | 29.50 | 58.80 | 57.96 |
| Costs of sales | 15.00 | 14.75 | 25.28 | 24.92 |
| Gross margin | 15.00 | 14.75 | 33.52 | 33.04 |
| Expenses | 12.00 | 12.50 | 29.50 | 29.75 |
| Operating profit | 3.00 | 2.25 | 4.02 | 3.29 |

Got it Pass eLearning Co**Supplementary Notes**

| | 2007 Actual \$m | 2008 Budget \$m | 2009 Forecast \$m | 2010 Forecast \$m |
|-----------------------|-----------------------|-----------------------|-------------------------|-------------------------|
| Interest paid | 0.00 | 0.00 | 2.50 | 2.50 |
| Profit after interest | 3.00 | 2.25 | 1.52 | 0.79 |
| Fixed assets | 15.00 | 15.00 | 34.00 | 34.00 |
| Current assets | 6.00 | 5.90 | 9.80 | 9.66 |
| Current liabilities | 3.75 | 3.69 | 7.35 | 7.25 |
| Equity | 24.75 | 24.59 | 26.15 | 25.91 |
| Debt | 0.00 | 0.00 | 25.00 | 25.00 |

Got it Pass eLearning Co**Supplementary Notes**

| | 2007 Actual \$m | 2008 Budget \$m | 2009 Forecast \$m | 2010 Forecast \$m |
|--|-----------------------|-----------------------|-------------------------|-------------------------|
|--|-----------------------|-----------------------|-------------------------|-------------------------|

| | | | | |
|--------------|-----|-----|-----|-----|
| Gross margin | 50% | 50% | 57% | 57% |
|--------------|-----|-----|-----|-----|

| | | | | |
|-----------------|-----|-------|-------|-------|
| Return of sales | 10% | 7.62% | 6.83% | 5.67% |
|-----------------|-----|-------|-------|-------|

| | | | | |
|----------------|------|------|------|------|
| Activity ratio | 1.21 | 1.20 | 1.15 | 1.14 |
|----------------|------|------|------|------|

| | | | | |
|----------------------|------|------|------|------|
| Return on net assets | 12.2 | 9.15 | 7.85 | 6.46 |
|----------------------|------|------|------|------|

| | | | | |
|-----|------|------|------|------|
| ROE | 12.2 | 9.15 | 5.80 | 3.04 |
|-----|------|------|------|------|

| | | | | |
|------------------------------|-----|-----|-----|-----|
| Industry sales (2000 100) | 125 | 135 | 140 | 138 |
|------------------------------|-----|-----|-----|-----|

Part (a) examines your knowledge of the implementation stage by asking a specific question on structure and whether you believe decentralisation has had any detrimental effect on Sportak. If you were to brainstorm the main issues regarding centralisation and

decentralization, and then see which apply in the context of the case, a comprehensive answer would be able to be obtained.

Part (b) would be best answered by mixing common sense with the key issues from strategic analysis, strategic choice and strategic implementation. Common sense would tell you that the business plan should include an overview of Sportak's business. More detailed information should be provided on the organisation's resources (6Ms), together with an overview of the business environment in which it exists (use PESTEL and five forces for inspiration). A clear description of the basis on which Sportak intended to compete should also be included (use Porter's generic strategies and Ansoff's product market matrix for inspiration) together with the likely returns the business is to make from the chosen strategy.

Part (c) requires you to apply the financial skills you have learned throughout your ACCA studies to give an overview of how viable Jerome's plans are.

Part (d) again would have been easily answered if you had approached your studies in the logical way suggested earlier and it specifically dealt with the how? Part of the strategic choice stage. (Use the internal, external or joint venture model for inspiration).

Summary

Hopefully you are now able to overview the strategic planning part of the syllabus in a more systematic and logical way. All you need to remember is the key steps of strategic analysis, choice and implementation. This should then set off another chain of words in your head, such as:

- strategic analysis (think 6Ms, think PESTEL and five forces and stakeholder constraints)
- strategic choice (on what basis do we decide to compete? Which direction should we choose? How are we going to achieve the chosen direction?)
- strategic implementation (resource management, organisational structure, management of change)

All that is necessary now is to use the framework in an applied way relevant to the question asked.

Adapted from an article originally written by Sean Purcell BA ACMA (a leading freelance lecturer for P3 and lecturer on the ACCA Study School and Train the Trainer Programme for P3 and SBL)

Chapter 12 COSO's enterprise risk management

Executive Summary

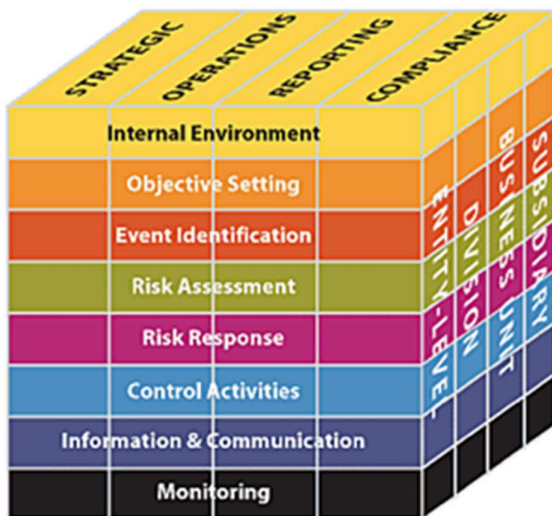
This article examines the guidance published by the Committee of Sponsoring Organisations (COSO).

COSO

The Committee of Sponsoring Organisations (COSO) was established in the mid-1980s, initially to sponsor research into the causes of fraudulent financial reporting. Its current mission is to: 'provide thought leadership through the development of comprehensive frameworks and guidance on enterprise risk management, internal control and fraud deterrence designed to improve organisational performance and governance and to reduce the extent of fraud in organisations.'

Although COSO's guidance is non-mandatory, it has been influential because it provides frameworks against which risk management and internal control systems can be assessed and improved. Corporate scandals, arising in companies where risk management and internal control were deficient, and attempts to regulate corporate behaviour as a result of these scandals have resulted in an environment where guidance on best practice in risk management and internal control has been particularly welcome.

The ERM model



The ERM model

COSO's enterprise risk management (ERM) model has become a widely-accepted framework for organisations to use. Although it has attracted criticisms, the framework has been established as a model that can be used in different environments worldwide.

COSO's guidance illustrated the ERM model in the form of a cube. COSO intended the cube to illustrate the links between objectives that are shown on the top and the eight components shown on the front, which represent what is needed to achieve the objectives. The third dimension represents the organisation's units, which portrays the model's ability to focus on parts of the organisation as well as the whole.

This article highlights a number of issues under each of the eight components listed on the front of the cube that organisations have had to tackle – issues which can be featured in exam questions for the Strategic Business Leader (SBL) exam, relating to sections B1 and F1 of the syllabus.

Internal environment

The internal environment establishes the tone of the organisation, influencing risk appetite, attitudes towards risk management and ethical values.

Ultimately, the company's tone is set by the board. An unbalanced board, lacking appropriate technical knowledge and experience, diversity and strong, independent voices is unlikely to set the right tone. The work directors do in board committees can also make a significant contribution to tone, with the operation of the audit and risk committees being particularly important.

However, the virtuous example set by board members may be undermined by a failure of management in divisions or business units. Mechanisms to control line management may not be sufficient or may not be operated correctly. Line managers may not be aware of their responsibilities or may fail to exercise them properly. For example, they may tolerate staff ignoring controls or emphasise achievement of results over responsible handling of risks.

One criticism of the ERM model has been that it starts at the wrong place. It begins with the internal and not the external environment. Critics claim that it does not reflect sufficiently the impact of the competitive environment, regulation and external stakeholders on risk appetite and management and culture.

Objective setting

The board should set objectives that support the organisation's mission and which are consistent with its risk appetite.

If the board is to set objectives effectively, it needs to be aware of the risks arising if different objectives are pursued. Entrepreneurial risks are risks that arise from carrying out business activities, such as the risks arising from a major business investment or competitor activities.

The board also needs to consider risk appetite and take a high-level view of how much risk it is willing to accept. Risk tolerance – the acceptable variation around individual objectives – should be aligned with risk appetite.

One thing the board should consider is how certain aspects of the control systems can be used for strategic purposes. For example, a code of ethics can be used as an important part of the organisation's positioning as socially responsible. However, the business framework chosen can be used to obscure illegal or unethical objectives. For example, the problems at Enron were obscured by a complex structure and a business model that was difficult to understand.

Event identification

The organisation must identify internal and external events that affect the achievement of its objectives.

The COSO guidance draws a distinction between events having a negative impact that represent risks and events having a positive impact that are opportunities, which should feed back to strategy setting.

Some organisations may lack a process for event identification in important areas. There may be a culture of no-one expecting anything to go wrong.

The distinction between strategic and operational risks is also important here.

Organisations must pay attention both to occurrences that could disrupt operations and also dangers to the achievement of strategic objectives. An excessive focus on internal factors, for which the model has been criticised, could result in a concentration on operational risks and a failure to analyse strategic dangers sufficiently.

Businesses must also have processes in place to identify the risks arising from one-off events and more gradual trends that could result in changes in risk. Often one-off events with significant risk consequences can be fairly easy to identify – for example, a major business acquisition. The ERM has been criticised for discussing risks primarily in terms of events, particularly sudden events with major consequences. Critics claim that the guidance insufficiently emphasises slow changes that can give rise to important risks – for example, changes in internal culture or market sentiment.

Organisations should carry out analysis to identify potential events, but it will also be important to identify and respond to signs of danger as soon as they arise. For example, quick responses to product failure may be vital in ensuring that lost sales and threats to reputation are minimised.

Risk assessment

The likelihood and impact of risks are assessed, as a basis for determining how to manage them.

As well as mapping the likelihood and impact of individual risks, managers also need to consider how individual risks interrelate. The COSO guidance stresses the importance of employing a combination of qualitative and quantitative risk assessment methodologies. As well as assessing inherent risk levels, the organisation should also assess residual risks left after risk management actions have been taken.

The ERM model has, though, been criticised for encouraging an over-simplified approach to risk assessment. It's claimed that it encourages an approach that views the materialisation of risk as a single outcome. This outcome could be an expected outcome or it could be a worst-case result. Many risks will have a range of possible outcomes if they materialise – for example, extreme weather – and risk assessment needs to consider this range.

Risk response

Management selects appropriate actions to align risks with risk tolerance and risk appetite.

This stage can be seen in terms of the four main responses – reduce, accept, transfer or avoid. However risks may end up being treated in isolation without considering the picture

for the organisation as a whole. Portfolio management and diversification will be best implemented at the organisational level and the COSO guidance stresses the importance of taking a portfolio view of risk.

The risk responses chosen must be realistic, taking into account the costs of responding as well as the impact on risk. An organisation's environment will affect its risk responses. Highly regulated organisations, for example, will have more complex risk responses and controls than less regulated organisations. The ALARP principle – as low as reasonably practicable – has become important here, particularly in sectors where health or safety risks are potentially serious, but are unavoidable.

Part of the risk response stage will be designing a sound system of internal controls. COSO guidance suggests that a mix of controls will be appropriate, including prevention and detection and manual and automated controls.

Control activities

Policies and procedures should operate to ensure that risk responses are effective.

Once designed, the controls in place need to operate properly. COSO has supplemented the ERM model by guidance in 'Internal Control – Integrated Framework'. The latest draft of this framework was published in December 2011. It stresses that control activities are a means to an end and are effected by people. The guidance states: 'It is not merely about policy manuals, systems and forms but people at every level of an organisation that impact on internal control.'

Because the human element is so important, it follows that many of the reasons why controls fail is because of problems with how managers and staff utilise controls. These include failing to operate controls because they are not taken seriously, mistakes, collusion between staff or management telling staff to over-ride controls. The COSO guidance therefore stresses the importance of segregation of duties, to reduce the possibility of a single person being able to act fraudulently and to increase the possibility of errors being found.

The guidance also stresses the need for controls to be performed across all levels of the organisation, at different stages within business processes and over the technology environment.

Information and communication

Information systems should ensure that data is identified, captured and communicated in a format and timeframe that enables managers and staff to carry out their responsibilities.

The information provided to management needs to be relevant and of appropriate quality. It also must cover all the objectives shown on the top of the cube.

There needs to be communication with staff. Communication of risk areas that are relevant to what staff do is an important means of strengthening the internal environment by embedding risk awareness in staff's thinking.

As with other controls, a failure to take provision of information and communication seriously can have adverse consequences. For example, management may not insist on a business unit providing the required information if that business unit appears to be performing well. Also, if there is a system of reporting by exception, what is important enough to be reported will be left to the judgment of operational managers who may be disinclined to report problems. Senior management may not learn about potential problems in time.

Monitoring

The management system should be monitored and modified if necessary.

Guidance on monitoring has developed significantly since the initial COSO guidance. At board level, the Turnbull guidance on the scope of regular and annual review of risk management has been very important.

COSO supplemented its ERM guidance with specific guidance on monitoring internal controls in 2009, based on the principle that unmonitored controls tend to deteriorate over time. The guidance echoes the Turnbull guidance in drawing a distinction between regular review (ongoing monitoring) and periodic review (separate evaluation). However weaknesses are identified, the guidance stresses the importance of feedback and action. Weaknesses should be reported, assessed and their root causes corrected.

Key players in the separate evaluation are the audit committee and internal audit department. Whether separate monitoring can be carried out effectively without an internal audit department should be a key question considered when deciding whether to establish an internal audit function. Once an organisation goes beyond a certain level of size and complexity, it becomes difficult to believe that an internal audit function will not be required.

The ERM model has provided a foundation for organisations to manage risks more effectively. However, managers need an awareness of the limitations of risk management and where the process could fail. Paper P1 questions have concentrated on organisations that have had serious shortcomings, as there is usually not enough to discuss about an organisation that is perfect!

Adapted from an article originally written by a member of the P1 examining team

Chapter 13 Strategic and operational risks

Executive Summary

Examining the risks in terms of their potential impact and probability of occurrence.

Risks are bound up with all aspects of business life, from deciding to launch a major new product to leaving petty cash in an unlocked box.

The SBL exam syllabus highlights risk management as an essential element of business governance.

The examiner has emphasised that being aware of all possible risks, and understanding their potential impact – as well as the probability of their occurrence – are important safeguards for investors and other stakeholders.

Introduction

Risks are bound up with all aspects of business life, from deciding to launch a major new product to leaving petty cash in an unlocked box. The SBL exam syllabus highlights risk management as an essential element of business governance. The examiner has emphasised that being aware of all possible risks, and understanding their potential impact – as well as the probability of their occurrence – are important safeguards for investors and other stakeholders.

In order to provide a structure for risk analysis, and to help allocate responsibility for managing different types of risk, risks need to be categorised appropriately. One method of risk classification is to reflect broad business functions, grouping risks relating to production, information technology, finance, and so on. However, directors also have to ensure that there is effective management of both the few risks that are fundamental to the organisation's continued existence and prosperity, and the many risks that impact on day-to-day activities, and have a shorter time frame compared with longer-term strategic risks. These two types of risk can be categorised as strategic and operational respectively. Having categorised risks, management can then analyse the probability that the risks will materialise and the hazard (impact or consequences) if they do materialise.

Strategic risks

Strategic risks are those that arise from the fundamental decisions that directors take concerning an organisation's objectives. Essentially, strategic risks are the risks of failing to achieve these business objectives. A useful subdivision of strategic risks is:

- **Business risks** – risks that derive from the decisions that the board takes about the products or services that the organisation supplies. They include risks associated with developing and marketing those products or services, economic risks affecting product sales and costs, and risks arising from changes in the technological environment which impact on sales and production.
- **Non-business risks** – risks that do not derive from the products or services supplied. For example, risks associated with the long-term sources of finance used. Strategic risk levels link in with how the whole organisation is positioned in relation to its environment and are not affected solely by what

the directors decide. Competitor actions will affect risk levels in product markets, and technological developments may mean that production processes, or products, quickly become out-of-date.

Responsibility for strategic risk management

Strategic risks are determined by board decisions about the objectives and direction of the organisation. Board strategic planning and decision-making processes, therefore, must be thorough. The UK Cadbury report recommends that directors establish a formal schedule of matters that are reserved for their decision. These should include significant acquisitions and disposals of assets, investments, capital projects, and treasury policies.

To take strategic decisions effectively, boards need sufficient information about how the business is performing, and about relevant aspects of the economic, commercial, and technological environments. To assess the variety of strategic risks the organisation faces, the board needs to have a breadth of vision; hence governance reports recommend that a board be balanced in skills, knowledge, and experience.

However, even if the board follows corporate governance best practice concerning the procedures for strategic decision making, this will not necessarily ensure that the directors make the correct decisions.

For example, the severe problems that the UK's Northern Rock bank faced were not caused by a lack of formality. Northern Rock's approach to risk management conformed to banking regulations, but its strategy was based on the assumption that it would continually be able to access the funds it required. In 2007, its funding was disrupted by the global credit crunch resulting from problems in the US subprime mortgage market, and UK Government action was required to rescue the bank.

The report *Enterprise Governance – Getting the Balance Right*, published by the Chartered Institute of Management Accountants (CIMA) and the International Federation of Accountants (IFAC) highlighted choice and clarity of strategy, and strategy execution, as key issues underlying strategic success and failure. Other issues identified in the report were the ability to respond to abrupt changes or fast-moving conditions, and (the most significant issue in strategy-related failure) the undertaking of unsuccessful mergers and acquisitions.

Managing strategic risks

Strategic risks are often risks that organisations may have to take in order (certainly) to expand, and even to continue in the long term. For example, the risks connected with developing a new product may be very significant – the technology may be uncertain, and the competition facing the organisation may severely limit sales. However, the alternative strategy may be to persist with products in mature markets, the sales of which are static and ultimately likely to decline.

An organisation may accept other strategic risks in the short term, but take action to reduce or eliminate those risks over a longer timeframe. A good example of this sort of risk, would include fluctuations in the world supply of a key raw material used by a company in its production. For instance, the problem can be global, the business may be unable to avoid it, in the short term, by changing supplier. However, by redesigning its production processes over the longer term, it could reduce or eliminate its reliance on the material.

Ultimately, some risks should be avoided and some business opportunities should not be accepted, either because the possible impacts could be too great (threats to physical safety, for example) or because the probability of success could be so low that the returns offered are insufficient to warrant taking the risk. Directors may make what are known as ‘go errors’ when they unwisely pursue opportunities, risks materialise, and losses exceed returns.

However, directors also need to be aware of the potentially serious consequences of ‘stop errors’ – not taking opportunities that should have been pursued. A competitor may take up these opportunities, and the profits made could boost its business.

Operational risks

Although boards need to incorporate an awareness of strategic risks into their decision making, there is a danger that they focus excessively on high-level strategy and neglect what is happening ‘on the ground’ in the organisation. If production is being disrupted by machine failure, key staff are leaving because they are dissatisfied, and sales are being lost because of poor product quality, then the business may end up in serious trouble before all the exciting new plans can be implemented. All of these are operational risks – risks connected with the internal resources, systems, processes, and employees of the organisation.

Some operational risks can have serious impacts if they are not avoided. A good example

of an operational risk is the failure to receive material sent by mail, as it was not sent by a secure method. This operational risk materialised for the UK Government taxation authority, HM Revenue & Customs (HMRC). In October 2007, the personal details of 25 million people, stored on two CDs, were lost in the internal mail. The fallout from the loss of these CDs included the resignation of HMRC chairman Paul Gray, due to the organisation's 'substantial operational failure'.

What happened concerning these CDs is an example of an operational risk that has a serious impact if it materialises even once. Other operational risks may not have serious financial (or other) impacts if they only materialise once or twice. However, if they are not dealt with effectively, over time – if they materialise frequently – they can result in quite substantial losses. Again, a good example to illustrate the latter, would be a situation regarding a concern that security measures at a factory might be insufficient to prevent burglaries. The impact of a single burglary might not be very great; the consequences of regular burglaries might be more significant.

Responsibility for operational risk management

Clearly, the board can't manage all operational risks itself. However, it is responsible for ensuring that control systems can deal appropriately with operational risks.

The board may establish a risk committee to monitor exposure, actions taken and risks that have materialised. The risk committee is likely to assess operational risks in aggregate, over the whole organisation, and decide which risks are most significant, and what steps should be taken to counter these. This may include setting priorities for control systems and liaising with internal audit to ensure audit work covers these risks.

The risk committee may be supported by a risk management function, which is responsible for establishing a risk management framework and policies, promoting risk management by information provision and training, and reporting on risk levels.

A key part of line managers' responsibilities is the management of the operational risks in their area. As well as ensuring specific risks are dealt with effectively, managers will be concerned with their local working environment and will deal with conditions that may cause risks to materialise. For example, they may need to assess whether employees are working excessively long hours and are more likely to make mistakes as a result. They will also supply information to senior managers to enable them to assess the risk position over the whole organisation.

Ultimately, employees will be responsible for taking steps to control operational risks. However, senior management is responsible for ensuring that employees, collectively, have the knowledge, skills, and understanding required to operate internal controls effectively.

Managing operational risks

It may be fairly obvious what the most significant strategic risks are and how important they are. But because of the number and variety of operational risks, accurate operational risk analysis can be more difficult, and can require evidence from a large number of different sources.

A key distinction, when defining different types of operational risk, is between low probability high impact risks and high probability low impact risks. The management of risks with low probability but severe impact may well involve insurance, for example a sporting venue insuring against the loss of revenue caused by an event being cancelled. Alternatively, for other risks, the organisation may have a contingency plan in place, such as the availability of alternative information technology facilities if a major systems failure occurs.

Any controls put in place to deal with low probability high consequence risks will normally be designed to prevent the risks occurring. Preventative controls would be considered necessary such as necessary in order to minimise the possibility of a poisonous chemical emission.

By contrast, risks that materialise frequently, but are unlikely to have a significant impact if they do, may be dealt with by controls that detect or correct problems when they arise. These controls will often reduce risks rather than eliminate them totally.

Conclusion

If risk management is to be effective and efficient, the board needs to understand the major risks that its strategies involve, and the major problems that could occur with its operations. Risk and initiative cannot be separated from business decision making; however, directors can ensure that a wide view is taken of risk management and thus limit the trouble that risks can cause.

Adapted from an article written by Nick Weller (a technical author at BPP Learning Media)

Chapter 14 Cyber security and the strategic business leader**Executive Summary**

Syllabus area E4 of the SBL study guide requires students to discuss, assess and evaluate the security of IT systems. This article explains why these skills are crucial for those seeking to become effective strategic business leaders and demonstrates how they can be applied in practice.

Syllabus area E4 of the SBL study guide requires students to discuss, assess and evaluate the security of IT systems. This article explains why these skills are crucial for those seeking to become effective strategic business leaders and demonstrates how they can be applied in practice.

Although awareness of cyber security risk has increased, many companies admit that they are not managing this risk effectively. UK government research published in 2019 revealed that 72% of FTSE 350 companies identified cyber threats as a high risk but 46% admitted that they did not understand the risks themselves (1).

This lack of understanding coincides with an increase in the frequency and impact of cyber-attacks. A 2019 Hiscox report found that 61% of companies experienced a cyber-attack over the preceding twelve months, up from 45% the previous year (2). Large companies (over 1,000 employees) are particular targets, with 74% reporting an attack in the past year. Furthermore, the costs of these attacks have risen dramatically. According to the same report, the average cost of an attack was \$369,000, up a disturbing 61% on the previous year.

Why does cyber security need special attention?

Although cyber security is best managed as part of an overall risk management programme, there are four factors that mean it requires special attention:

Increased value of data

The volume and value of data available has increased exponentially. ACCA reports that '90% of the [40 trillion GB of] data in the world has been created since 2016'. (3)

Advances in machine learning and artificial intelligence allow patterns to be analysed that revolutionise the way organisations interact with their stakeholders. This trend caused *The Economist* to report in 2017 that 'the world's most valuable resource is no longer oil, but data.' (4)

A lack of awareness of the vulnerability of personal data

In 2010, reports emerged of Mark Zuckerberg having described Facebook users as 'dumb' for being so ready to part with their personal data. (5)

At the time, there was no public awareness of how this data might be used but, in 2018, it emerged that Cambridge Analytica had harvested the personal data of 50 million Facebook users as part of a strategy to target and influence voters in democratic elections. (6)

Storing and sharing data

Cloud technology enables organisations to store and share huge volumes of data. However, the action of making data available outside organisations creates channels which are open to being exploited through unethical or illegal behaviour.

The inevitability of software bugs

Software is now so complex that it is beyond the scope of any human to identify every possible weakness. For example, the software used in the average new car contains over 100 million lines of code, leaving the potential for flaws or 'back doors' to exist that could be exploited.

Measures to promote cyber security

The UK government became so concerned at the lack of engagement with cybersecurity that, in 2016, it set up the National Cyber Security Centre (NCSC). This organisation recommends ten steps to promote cyber security within an organisation:

1. Set up your risk management regime

As part of good corporate governance, organisations should already have an effective risk management policy in place. However, the technical complexity of cyber security creates a specific risk that directors fail to engage with the issue, even though it is a critical risk for any organisation. It is therefore crucial that any general risk management regime refers explicitly to cyber security risk. The subsequent steps give examples of specific matters the board should consider.

2. Network security

In the same way that an organisation's offices are kept physically secure, the perimeter of its network needs to be kept secure in order to prevent unauthorised access.

3. User education and awareness

A network is only as secure as its weakest link, so it's crucial that all those authorised to access an organisation's network understand how they might be exploited by a hacker.

4. Malware prevention

Malware is a generic term that covers all forms of malicious software, including viruses spyware and ransomware. Organisations and individuals can protect against malware by subscribing to software that screens for such infections. With new malware threats emerging all the time, it's crucial that anti-malware software is kept fully up-to-date – many reputable providers provide daily updates.

5. Removable media controls

The ability to transfer media via removable media creates a key weakness that hackers can exploit. A 2019 report from Dtex Systems reported that 74% of staff surveyed were able to circumvent security controls to use unsanctioned portable applications such as USB sticks (7).

Organisations clearly need to be more robust in regulating the use of such media.

6. Secure configuration

In the same way that removable media needs to be controlled, hardware added to an organisation's network needs to be configured in a way that restricts unauthorised use. An obvious example here would be a standard configuration for any laptop connected to the company network.

7. Managing user privileges

The separation of duties is a widely used control, but the 2019 Dtex report discovered that 95% of users actively attempted to circumvent corporate security policies. Much of this would not have been malicious (how many people have allowed someone else to log on using their password so that they can do their job?). Nevertheless, it creates a culture that dramatically undermines basic controls.

8. Incident response

Cyber security attacks are inevitable. When they happen, an organisation needs to have a

robust response that minimises the immediate threat (eg off-site back-ups). However, what happens after an attack has been neutralised is equally important – the organisation needs to learn from the incident in order to minimise the risk of it recurring.

9. Monitoring

An organisation that spots an unsuccessful cyber attack will be able to implement additional measures that target potentially sensitive areas. For example, some organisations send fake phishing emails to staff – messages that could result in unauthorised users gaining access to sensitive information. Staff that fall for the trick can be targeted for additional training.

10. Home and mobile working

The increase in remote working requires organisations to permit network access from different geographical locations. Effective controls in this field include the use of a Virtual Private Network (VPN) which should only be accessed using appropriately configured devices (see 6 above).

The role of the finance department in managing cyber security

A recent report by ACCA, *Cyber and the CFO*, highlights the need for chief financial officers (CFOs) to be much more pro-active in managing cyber risk (8).

It explains that, while there are complex IT issues involved, 'this should not absolve the finance team from involvement... It falls to the CFO to take the broader view of cyber security as a commercial and business-wide risk rather than a technical issue.'

The ACCA report recommends several specific actions for the CFO to take:

1. Redefine risk and resilience

As cyber criminals become ever more sophisticated, the report recommends a 'zero trust' model, where all users and equipment are systematically verified before gaining access to a network. This can be seen with the 'two step verification' techniques being adopted by many banks and consumer service providers.

2. Focus on recovery plans

Preventing cyber-attacks is a noble ambition but it's virtually impossible to achieve. It's therefore crucial to have plans in place to manage any attack itself but also, crucially, the recovery afterwards.

3. Audit your supply chain

A system is only as strong as its weakest link so organisations need to place as much emphasis on the cyber security protocols of any connected suppliers as it does on its own systems and controls.

4. Invest in cyber insurance

Insurance will help to minimise the damage caused by a cyber attack. For this to be effective, the CFO needs to help the board to quantify the financial damage that an attack could cause. However, while it may be tempting to pay off a ransomware attacker, such an action is likely to make the organisation considerably more attractive to other attackers.

Conclusion

The ACCA report concludes with the following warning:

'Do not wait for a cyber attack to occur. Do not wait for the fine or the measurable reputational loss. Finance leaders need to recognise that cyber risk is one that is very relevant to them. Ensure that you are fully up to date on the nature of the risk that the organisation faces on an on-going basis.'

As the strategic business leaders of tomorrow, students need to demonstrate a good awareness of cyber security issues and be ready to discuss, assess and evaluate the controls that an organisation has (or doesn't have) in place.

References

- (1) HM Government, 'FTSE 350 Cyber Governance Health Check 2018', 2019
- (2) Hiscox, 'Cyber Readiness Report', 2019
- (3) ACCA, [*Machine learning: more science than fiction*](#), April 2019
- (4) *The Economist*, 'The world's most valuable resource is no longer oil, but data', 6 May 2017
- (5) *Business Insider*, 'Well, These New Zuckerberg IMs Won't Help Facebook's Privacy Problems', 13 May 2010

(6) *The Guardian*, 'Revealed: 50 million Facebook profiles harvested for Cambridge Analytica in major data breach.' 17 March 2018

(7) DTex Systems, 'Insider Threat Intelligence Report', 2019

(8) ACCA, *Cyber and the CFO*, March 2019

Chapter 15 Getting connected to the Internet of Things**Executive Summary**

The Internet of Things (IoT) is all about connections. The number of objects and devices being IoT-enabled by connected sensors, processors and transmitters has greatly increased.

The Internet of Things (IoT) is all about connections. The number of objects and devices being IoT-enabled by connected sensors, processors and transmitters has greatly increased.

They not only collect data but communicate and interact with each other, sharing information and helping to create the larger picture that Big Data provides. Smart devices, interconnected devices that can operate to some extent autonomously, are not only involved in data collection but can also be used to control conditions in the physical world.

Businesses, however, need to get beyond the technology and the potential to gather vast amounts of data. They have to consider how the IoT can be part of their commercial model. The IoT has many strategic and operational uses that go right across business sectors. The IoT is relevant to areas in Section E of the SBL syllabus, including the need to explore opportunities for adopting new technologies and the potential application of information technology to support e- business.

Devices

Smart devices can be found just about anywhere. For the home there are devices that can turn on the coffee machine when you wake up, lock the doors when you leave the house and put on your favourite music when you get home. Travelling to work, smart devices can collect data about traffic volumes, so that you can receive alerts warning you of traffic jams and advising you to take a different route. In the office, smart desks have been developed that can tell you when you've sat for too long in the same position and it's a good time to stand up.

Uses

- **Helping with particular tasks** – the IoT can help enable better-targeted working processes. The oil and gas industry has been able to build models based on seismic images to improve the precision of exploration for new reserves. Data about the conditions that products are kept in can be used to help predict with precision the life of individual products within a larger batch. This is particularly important in the food industry, where shelf life can vary according to harvesting, holding, processing and distribution arrangements.

- **Generating efficiencies** – the information smart devices make available within manufacturing operations can help prevent bottlenecks. Efficiencies also include reduction in the use of resources, by, for example, using smart devices for better energy management in buildings. In agriculture, sensors on farms enable farmers to monitor soil conditions and irrigation levels, optimising their water and fertilizer use.
- **Monitoring for potential problems** – devices are able to give warnings to remote locations of security problems, such as open windows. The data devices provide can also enhance the effectiveness of procedures designed to prevent problems occurring. Predictive maintenance involves use of data relating to the condition of equipment to estimate when maintenance should be performed. The timing of maintenance will be partly determined by when it is cost-effective, but also trying to ensure that it happens before there is likely to be a loss in performance.
- **Underpinning strategic development** – in the automotive industry 3D printers can be used to shape pressing tools by printing the shape directly onto the steel granulate. This helps enable car designs to be tailored to customer requirements.

Sector examples

The medical sector has found many uses for smart devices. Devices in the home can provide alerts that medical emergencies, such as falls, have occurred. They can also enable continuous remote monitoring of blood pressure and heart rate, and also responses to treatment.

In the transport sector the proliferation of smart devices such as traffic cameras, sensors and vehicles' tracking modules can be used for longer-term objectives, as well as warning motorists of traffic problems ahead. They can identify the most-frequently taken routes and provide data that can be used as a basis for decisions about simplifying those routes.

Problems

As always, security is an important concern. A significant criticism of the IoT is that development of applications has not been accompanied by sufficient development of security. In some instances the consequences of hacking could be life-threatening.

Privacy and breaching data protection regulations are also serious concerns. The more information that devices provide, the more is known about what individuals are doing,

leading perhaps to a greater ability to predict behaviour. Individuals may fear being watched and be afraid of whether the inferences drawn from data collected about them can be used to 'control' their behaviour. Compliance with data protection regulations is complicated by regulations continuing to develop and differences in regulations between countries.

Other technical issues include platform fragmentation, the problem of providing applications that can work with IoT devices that use a variety of hardware and software. One device becoming obsolescent can disrupt the whole network of which that device forms a part. Data storage and processing costs may be large. Problems with connection, gathering and understanding data may hinder IoT application, emphasising the need for expert staff to be involved.

In addition, many IoT applications do not get beyond the pilot or development stage. Developments can concentrate too much on the technology, and not establish early on whether there is a convincing business case. The time horizons for successful implementation may be felt to be too long-term. Barriers to implementation may also include the limitations of the hardware being used by businesses or the insufficiency of their information systems' infrastructure. Old legacy systems may be a particular issue, as businesses may not want to replace all their computer equipment for new devices that can accommodate the IoT.

The future

IoT applications continue to develop across commercial, infrastructure, manufacturing and industrial sectors. They are also increasing in scope, with smart design being built into city planning. For businesses however, it remains difficult to predict the pace at which IoT applications will develop, and whether they will creep into businesses' environment or suddenly and quickly transform it.

Written by a member of the Strategic Business Leader examining team

Chapter 16 Applying big data and data analytics in Strategic Business Leader

Executive Summary

The article provides an overview of big data and what it is and its characteristics. It then explains data analytics and what types of analytics can be of most use to business leaders.

The article will also look at some examples of how using big data and data analytics can improve business performance, focusing on aspects such as being sceptical about the use of data and, most importantly, how important it is to use data ethically, responsibly and securely to minimise reputational and financial risk.

Syllabus area E2 in the Strategic Business Leader study guide contains the following outcomes:

a) Discuss how information technology and data analysis can effectively be used to inform and implement organisation strategy.^[3]

b) Describe big data and discuss the opportunities and threats big data presents to organisations.^[2]

c) Identify and analyse relevant data for decisions about new product developments, marketing and pricing.^[3]

The article will first give an overview of big data and what it is and its characteristics. It will then explain data analytics and what types of analytics can be of most use to business leaders. The article will also look at some examples of how using big data and data analytics can improve business performance, focusing on aspects such as being sceptical about the use of data and most importantly how important it is to use data ethically, responsibly and securely to minimise reputational and financial risk.

This article is also written to explain what an SBL candidate would need to know to apply these outcomes in a potential examination question. The above outcomes essentially cover three themes. The first is how big data and data analytics can inform and implement strategy; the second is how big data and data analytics can provide new opportunities and present new risks for businesses and the third is how big data and data analytics helps business leaders make better and more effective business decisions in a variety of ways, in order to create and sustain business value.

What is big data?

Big data is about much larger, more complex data sets in all forms being available to businesses, from structured and semi structured to completely unstructured data. It comes from a variety of new and existing sources and these are increasing as more and more people carry out most of their activities on electronic devices where the data is recorded. Data therefore has a great deal of potential value.

Data which is not used or analysed has no value, but value can be added to data if it is cleaned, processed, transformed and analysed. Therefore data collected can be considered

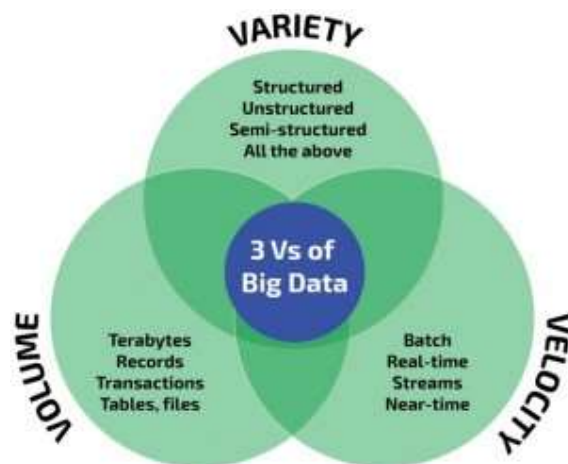
to be the raw material as in a manufacturing process. Some of this raw material is unrefined and some refined, such as structured and unstructured data. This data needs to be stored in a virtual warehouse such as the cloud. The cleaning and transformation of the data into a suitable form for analysis is really where the value is being added, so that the data can become the finished product – which is useful information which needs to be delivered or communicated to the user. Reliable, timely and relevant information is what the business leader needs in order to answer key business questions and make more informed business decisions.

Today, big data has become an important form of organisational capital. For some of the world's biggest tech companies such as Facebook, a large part of the value they offer comes from their data, which they are constantly analysing to produce and develop new revenue streams.

Sophisticated data analytics is about accessing the data which is useful for decision making and the three characteristics that big data has to improve the quality of decision making are:

- **Volume** – for reliability
- **Velocity** – for timeliness
- **Variety** – for relevance

These are known as the three Vs of big data – **see picture below**.



Volume

The amount of data matters greatly and the more that can be accessed the better. Most of this may have no value, but no one will know until they try and structure it and use it. This data can come from a wide range of sources, but could include social media data, hits on a website, or results from surveys or approval ratings given by consumers. For some organisations the sheer amount of this data will be difficult to manage unless the organisation has the right capabilities, including adequate storage and processing capacity. The main thing about the volume of big data is the additional reliability it gives the data analyst. As any statistician knows, the more data you have, the more reliable your analysis becomes and the more confident you can be about using the results you obtain to inform decision-making

Velocity

Velocity is the rate at which data is received and used. In the modern world, transactions are conducted and recorded in real time. As people increasingly shop with debit and credit cards and use their phone apps, these transactions are updated immediately.

Stores themselves know exactly how much inventory they have and the sales they are generating on a transaction by transaction basis and because customers transact with them electronically, they also know a lot more about their customers and their buying patterns. The banks too, immediately know that funds have gone out of customers', and into their suppliers' accounts in real time.

Variety

Variety refers to the many types and sources of data which are available. Traditional data types were more structured. With the rise of big data, data comes in new unstructured types. This also comes in a variety of forms. These include numerical data, text, audio, pictures and videos. All these require additional processing to transform them into meaningful and useful information which can be used to support decision-making, but being able to access them and use them provides richer information for the business leader which can make the information obtained from the data analysis more relevant and significant than larger amounts of data from more structured sources.

The veracity of big data and the need for scepticism

The three Vs discussed above are all clear benefits of big data. However, the data analyst must be sure that the data they are using to perform data analytics has veracity. Veracity means reliability and robustness and it is no good having large amounts of data in real time from a wide range of sources unless it can be relied upon. Finding value in big data isn't only about analysing it, it is a process of discovery which requires insightful analysts to recognize patterns and trends, and for business leaders to ask the right questions, to make informed assumptions, to accurately predict behaviour and come up with relevant solutions. If for any reason the original data is somehow unreliable, assumptions can be wrong, or the interpretation of the original business question or issue might be incorrect. In these circumstances the data analysis may yield incorrect or irrelevant information. It is therefore important that the data analyst or business leader, using the findings of data analysis, is sufficiently sceptical of the information that comes out of the data analytics process and properly challenges or verifies the information received.

Data analytics techniques

There are unlimited ways in which data can be analysed, depending on the number of business questions which can be asked by business leaders about the businesses which they lead. Essentially the data analytics process should always begin with posing a specific business question such as the following:

- Are we losing money or inventory due to fraud and error and if so where and how much exactly are we losing and why?
- Which products or customers are the most profitable and why?
- How can I predict my sales if the weather or other factors change?
- What is the cheapest way of distributing our goods from the warehouses to the stores?
- At what price should I sell my new product to maximise my profit?

There are many more of these questions and the SBL examination could address such questions and require the candidate to assess how such problems could be resolved and the solutions arrived at could involve some application of their knowledge about data analytics.

Essentially there are three types of data analytics:

- Descriptive
- Predictive

- Prescriptive

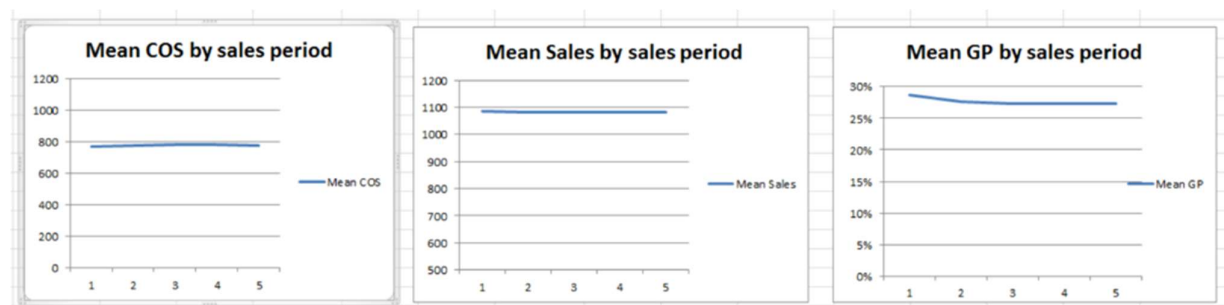
Descriptive analytics

Descriptive analytics is the analysis of data to observe what has been and is currently happening. Examples of this could be to analyse data by product, by outlet and by customer. Such analytics would allow the business leader to observe past trends, to analyse and classify data in different ways to draw conclusions about the data which might be relevant to informing strategy or to support or make more effective decisions, such as minimising risks or exploiting opportunities.

Often descriptive analytics is enhanced by the use of graphs or charts as commonly available in spreadsheet packages and pivot tables are particularly useful for presenting information in different ways. Pivot tables are a powerful spreadsheet tool which allows the business analyst to reclassify, filter and present information in a variety of ways so that better visualisation of the data and insights into it can be achieved.

An example of this is where retail data on the sales, cost of sales (COS) and gross profit margin (GP) in six retail outlets of a range of five products within each store are tracked over time to establish trends.

By looking at the overall figures for the company as a whole, or even by individual product across the company or for a store as a whole, the business leader may not notice any unusual trends or departures from the expected levels, from a chart or graph of these measures. **See charts below on how all these metrics are reasonably constant.**



Only by analysing and charting these trends more closely by product in each individual store (such as by using pivot tables) could the business leader detect if and where there is any specific fraud or loss and such discrepancies would become more apparent if this type

Got it Pass eLearning Co**Supplementary Notes**

of micro level descriptive analysis is undertaken. In the above example it looks like there was a problem with Product 2 in Store 6 – **see below**.



In the above example when the trend for Product 2 in Store 6 is examined more closely, it can be seen that the GP margin falls from 33% down to about 17% and it is nothing to do with sales which remain constant, but caused by a significant change in COS which rises from just above \$800 in periods 1 and 2 to \$1000 by period 5. In this case the business leader would be looking at a potential loss or theft of inventory relating to this product and would need to investigate further.

Predictive analytics

Predictive analytics involves using techniques to allow the business leader to evaluate strategies and to anticipate strategic outcomes depending on which scenarios play out. 'Scenario Manager' in Excel is an excellent tool for doing this and business leaders. Another spreadsheet tool is the Data Analysis Pack within Excel which allows business analysts to carry out multiple linear and nonlinear regression and a range of other statistical techniques on data. This allows the analyst to test the relationship between independent or input variables with a dependent or output variable. An example of this is where weather conditions such as hours of sunshine, amount of rain and temperature levels can affect sales of certain items, such as barbecues or cold drinks. Knowing how well these factors are associated with the dependent variable in the past, such as the sales of certain products, allows business leaders to predict future sales more accurately when the independent variables are established.

However, when using such techniques, a degree of scepticism must be applied because sometimes whilst some independent variables are good predictors of the dependent variable they may not be the causes. Take the price of petrol as the independent variable and the sales of motorcycle helmets as the dependent variable. The price of petrol is a

Got it Pass eLearning Co**Supplementary Notes**

good predictor of the sales of motorcycle helmets as there is a very high positive correlation between the two, but one is not the direct cause of the other. This is because as the price of petrol rises, the sales of motorcycles increase because they use less fuel. But because in most countries the law requires the motorcyclist to wear a helmet for safety reasons, the outcome is that the sales of motorcycle helmets, being a complementary product, also increases.

Prescriptive analytics

Prescriptive analytics is potentially the most powerful form of data analytics for decision makers and business leaders and is the field of analytics which is concerned with optimisation, such as maximising sales, minimising costs or maximising profit. Prescriptive analytics draws upon techniques which are commonly available in spreadsheets such as 'Goal Seek' and in particular 'Solver'.

A good business example of using solver as a data analytics tool is shown below with a problem to minimise transportation costs:

A company wishes to minimise its costs of delivering televisions from three depots (D1, D2 and D3) to three stores (Store 1, Store 2, and Store 3).

The problem is set out on an Excel spreadsheet – **see below**.

Distances between Depots and Stores:

| | Store 1 | Store 2 | Store 3 |
|----|---------|---------|---------|
| D1 | 22 | 33 | 40 |
| D2 | 27 | 30 | 22 |
| D3 | 36 | 20 | 25 |

Cost of TV delivery per mile: £5

TVs shipped from Warehouses to Stores:

| | Store 1 | Store 2 | Store 3 | TVs transported | TVs available at each depot |
|---------------------------|---------|---------|---------|-----------------|-----------------------------|
| D1 | 2000 | 500 | 0 | 2500 | 2,500 |
| D2 | 0 | 1100 | 2000 | 3100 | 3,100 |
| D3 | 0 | 1250 | 0 | 1250 | 1,250 |
| Received | 2000 | 2850 | 2000 | | |
| Store Capacity | 2,000 | 3,000 | 2,000 | | |
| Total distance (TV/miles) | | | | | £812,500 |

Solver Parameters

Set Objective: **E\$22**

To: ☐ Max ☒ Min ☐ Value Of: 0

By Changing Variable Cells: **C\$15:E\$17**

Subject to the Constraints:

- C\$18:E\$18** <= **C\$20:E\$20**
- F\$15:F\$17** = **F\$15:F\$17**

☒ Make Unconstrained Variables Non-Negative

Select a Solving Method: **Simplex LP**

Solving Method: Select the GRG Nonlinear engine for Solver Problems that are smooth nonlinear. Select the LP Simplex engine for Linear Solver Problems, and select the Evolutionary engine for Solver problems that are non-smooth.

In the above example, the cost per mile of delivering TVs; the distances between depots and the stores and the capacities of the stores to hold TVs are given.

From the solver parameters table displayed, it can be seen that the Solver objective is to minimise the total cost in the yellow cell E22, subject to the constraints that the total allocations of TVs to each store from all depots cannot exceed the maximum capacity of the store to hold TVs and that the total number of TVs transported from the depots cannot exceed the number of TVs held at each depot. The optimal solution is presented in the green figures shown in the range C15:E18 which the model changes to find the optimal or best solution.

Applications data analytics in future SBL exams

In SBL, students would not be expected to carry out such analysis as has been shown in this article, but these have been discussed to give students some insight into the type of analytics which can be carried out. This would normally be done by expert data analysts on the behalf of someone in the role of a business leader.

Students studying for SBL only need to be aware of how big data and such techniques of data analytics can be of use in leading or managing a business more effectively.

Candidates need to be aware that using data effectively is critical to a successful business and a key leadership trait is being able to interpret findings prepared by experts in data analytics in a sceptical, but insightful way, in order to make sound decisions.

Referring to the data analytics outcomes in SBL set out at the beginning of this article, it is possible to anticipate how big data and data analytics might be examined in a wider leadership examination by the examining team.

First of all, knowledge of big data characteristics and the wider benefits of big data and the ability of new data technologies to collect, store and process such data is an important business capability.

A business needs to have strategies to develop these capabilities to become successful and to compete more effectively.

An SBL examination might include a business which is losing or gaining competitive advantage because of its data analytics capabilities and require the candidate to identify these issues and consider ways to improve or exploit these capabilities.

An SBL examination might look at a company facing threats from disruptive technologies which need to be safeguarded against. Such threats might be from competitors like 'Rent a Room' which was featured in the December 2018 exam, but could also include security threats from people using technologies to steal data from companies or the risk of companies using data irresponsibly themselves and being threatened with litigation from the owners of such personal data, such as in the Facebook situation, and determining how this can be prevented.

Other scenarios could include situations involving business leaders using the findings of data analytics inappropriately or failing to exercise sufficient scepticism about the information they obtain from the data being analysed, or using such information unethically.

Finally, an SBL examination might include exhibits related to data analytics such as a spreadsheet, charts or multiple regression outputs and ask students to interpret or apply the findings, exercising scepticism to establish to what extent such information can be relied upon. These exhibits might include considering the best way to utilise scarce resources, to minimise costs in producing a range of products or how to optimise pricing or sales volume and the implications of doing this.

SBL candidates must be aware that big data and data analytics is a fast growing and emerging area which will apply across many business functions including, accountancy, audit, performance management, sales, marketing production and procurement. It is therefore very important that candidates read widely about these developments, but more importantly understand how such developments are relevant to improving business leadership.

Written by a member of the *Strategic Business Leader* examining team

Chapter 17 E-commerce

Executive Summary

This article discusses business-to-business and business-to-consumer e-commerce and benefits for business, as well as the social and employment costs involved.

Introduction

E-commerce is now synonymous with the internet. Users – private or corporate – can communicate with web-based online stores using a web browser such as Microsoft Explorer or Netscape Communicator. An internet store provides all the facilities a customer needs, including a product catalogue, a virtual shopping basket, and a secure credit card payment system.

In theory, the internet has no geographical, political or temporal boundaries. It has a common infrastructure available to all. The universal availability of access to the internet, while not radically changing logical processes, has created new opportunities and removed some of the physical limitations of traditional methods of conducting business.

Those studying the Accounting in Business (AB) exam may be interested in the social and employment consequences of e-commerce. For Strategic Business Leader candidates, e-commerce is now a weapon of competitive strategy, offering the possibility of new products and services, more efficient ways of performing traditional business processes, and new distribution channels.

Business-to-business (B2B)

E-commerce

E-commerce can be simply defined as conducting business transactions over electronic networks by way of linked computer systems. When the concept was originally introduced, it was envisaged that it would mainly involve business organisations linking their computer systems to conduct business with each other more speedily, efficiently and economically.

B2B e-commerce is well-established and is still a fast-growing area. Examples include companies linking to their suppliers to facilitate Just-In-Time (JIT) stock control. To enable this to happen, participating companies have had to agree on interface and application standards. Many office equipment and consumable suppliers can now take orders online and provide direct delivery to business customers.

One of the key drivers associated with B2B e-commerce is the overhaul of inefficient trading processes. Companies can link directly to suppliers, check availability of products, and then place orders and track shipments without delay or human assistance. In an increasingly competitive world, the best businesses are using new technologies to clarify customer demand, target marketing efforts more precisely, tighten business processes, and investigate new methods of distribution.

Business-to-consumer (B2C)

E-commerce

The volume of B2B e-commerce has been overtaken in the last five years by the growth of consumer e-commerce applications as the general public (B2C) increasingly conduct business over networks with commercial and public sector organisations. The catalyst for B2C e-commerce has been the growth in the number of people who have access to both a home computer and the internet. Most e-commerce applications are now internet-based, trading goods and services. Other terms used to refer to this practice include e-business, e-tailing and e-trading.

Business activities

Commerce refers to the activities in which an organisation or individual engages in order to complete a transaction. Most stages in the lifecycle of a product or service can be conducted in an e-commerce environment. For example, a book retailer might undertake the following e-commerce activities:

- market research
- advertising
- providing product information
- contacting customers
- taking orders
- tracking shipping
- receiving and processing payments
- ordering stock from publishers.

The list of activities or logical processes does not differ significantly from the list of business activities that the organisation has always carried out. The difference is that the company can conduct its retail business by using computers and telecommunications technologies instead of, or in addition to, operating stores.

Benefits for business

Some of the organisational benefits of doing business over the internet include the following:

- Business can be conducted 24-hours-a-day, seven-days-a-week.
- Products can be supplied to anyone, anywhere in the world (as long as there is an economic and reliable distribution channel).
- Suppliers can respond quickly to customer requirements.
- Suppliers can build a one-to-one relationship with customers. Through search tools and customer profiles, information can be tailored to customer requirements on demand. Direct communication results in improved pre and post-sales support.
- Customers can access up-to-date information – expensive printed catalogues and service guides can be replaced by a single electronic product database (which must be kept up to date at all times).
- Email distribution is cheaper than direct mail, and providing the information on a website is cheaper still if users can be encouraged to access it for themselves.
- The overheads of maintaining a physical retail outlet are reduced.
- Routine business operations can be automated, saving time and money – the supply chain is shortened so delivery times and costs are reduced.
- Staff costs can be reduced – standard enquiries and sales can be handled automatically via software, leaving staff with time to handle the difficult or higher added-value transactions.

- Entirely new services can be developed – for example, software and music can be delivered instantaneously and cheaply via the internet.

The self-serve economy

Email and websites are as easily, and readily, accessible as telephones and faxes. As a result, consumers are becoming more confident in the use of electronic media to conduct all kinds of transactions, from transferring money between bank accounts, to reserving film or theatre tickets, to ordering books online. The willingness of consumers to help themselves, and to make new technologies part of their daily lives, bypassing the shop assistant and customer service representative, is the principal characteristic of the self-serve economy. Self-serve characteristics, valued and required from an e-commerce service include availability, reliability, choice, speed, and convenience. A well-run and efficient e-commerce operation will deliver the following benefits to consumers.

- 24-hour shopping, seven-days-a-week.
- Global choice and access to a wider range of goods and services than in any local retail store or shopping centre.
- Lower prices – because of reduced operating costs and wider competition.
- Ease of use when identifying and browsing the choices available.
- Rapid response to orders – not as fast as retail off-the-shelf, but few retail chains provide their complete product offering at every outlet, and frequently products have to be ordered.
- For products that can be delivered electronically, such as software, video, newspapers and music, supply is instantaneous without any delay caused by intermediaries.

Social and employment costs of e-commerce

Although the benefits of e-commerce are significant, they do not come without the risk of some longer-term social costs.

- If substantial numbers of residents of small communities choose to shop on the internet, local stores may not be able to compete and may have to close. For those who do not have, or do not wish to have access to the internet, such closures could lead to social deprivation.
- Many aspects of electronic shopping are automated and fewer staff are needed to process orders, leading to a possible rise in unemployment in certain economic sectors.
- E-commerce businesses have access to global markets but they are also subject to global competition. This means that costs and working practices need to remain flexible to cope with changing consumer demands and competitor activity. Suppliers can choose to operate from offshore low-cost bases. This has a particular impact on high wage/high social cost economies which may find that jobs are exported to lower cost economies.
- Flexibility to operate offshore and to buy internationally means that it is very difficult for national governments to police the legality of operations and to ensure the quality and safety of some products supplied (eg medicines).
- Ensuring the reliability, security and integrity of data and operations can be a problem – electronic hacking is often one step ahead of the security industry.

E-commerce – a glossary of terms

Internet development

E-commerce would not have developed so rapidly without the global network of computers which we now call the internet. In the 1960s, the US government developed the connectivity standards to network computers for defence research purposes. The agency responsible for managing and developing the network, and linking together universities and defence research establishments, was called the Advanced Research Project Agency (ARPA). The ARPANET became the internet. At the core of its design philosophy was flexibility and resilience – enabling new computers to be easily linked and, in the event of any catastrophe destroying one or more computers, for the remainder of the network to be able to continue to function.

Over the following 30 years, the US National Science Federation (NSF) played a guiding role in developing the network. The developing internet was mainly used as a communications tool in the scientific and academic communities for electronically transferring and exchanging research materials. In 1989, the NSF opened the internet to commercial network traffic. Then, in 1992, Tim Berners Lee, working at the European Laboratory for Particle Physics, created the world wide web (www).

While we tend to use the terms internet and world wide web interchangeably, the internet describes the entire system of networked computers and the World Wide Web describes the method used to access information contained on computers connected to the internet. The availability of a common internet infrastructure – of computers, networks and protocols – and the development of an easy to use Graphical User Interface (GUI) have been the catalysts for the growth of e-commerce. It has created an open community – easy to join and easy to use.

Hyperlink

This is the highlighted text on a web page. You can click on a hyperlink and be routed to another web page, either on the same website or to a different website anywhere in the world. Hyperlinks are designed and set up to enable consumers to easily navigate and find information and purchase products.

Intranet

This term refers to a closed community of users, often within an organisation. intranets are designed to be used for internal business purposes only. It uses the same standards and protocols as the internet, but with increased password and security protection. Intranet websites can look just like the internet websites, but normally a firewall surrounds the intranet to prevent access by unauthorised users. A firewall examines all requests and messages entering and exiting the intranet and blocks any not conforming to specified criteria.

Extranet

An extranet is an extension of an organisation's intranet. The difference is that an extranet is accessible to selected people or groups outside the organisation. Many B2B transactions are made over extranets. An individual can enter an organisation's public website on the internet, obtain a password authorisation and then be routed to the organisation's extranet to conduct transactions and obtain information not available to the public. Extranets are frequently used to connect an organisation's corporate intranet with the intranets of the organisation's suppliers, distributors and corporate customers.

Web browsers

Internet users (private or corporate) communicate through their web browsers (such as Microsoft Explorer or Netscape Communicator) with websites. The web browser is a software utility program with a Graphical User Interface which helps users navigate through the web. It takes a request and then transmits and receives information from other users or information providers. Using a browser, the user does not need to know the format and location of the information required. They can jump from site to site by clicking on hypertext links.

Navigation aids

Website developers create navigation aids to enable customers to navigate their way around a website. A navigation aid can be hyperlink text, buttons, and tables of contents or graphical symbols such as icons or pictures. Navigation aids are designed to allow users to visit a website and conduct their transactions instinctively, quickly and easily, moving between pages and re-tracing steps as necessary.

Website search tools

An online store can use a search tool to help customers quickly find products. Techniques include simple features such as drop-down lists, where customers click a downward pointing arrow to display a list of products or specifications from which they may choose. Another technique is inviting the entry of key words which trigger a site search. The challenge for the designer is to pre-identify as many alternative (or even misspelt) versions of potential key words as possible. Most website search tools use indexing robots – software which electronically visits a site, follows all links contained therein, and automatically indexes the contents.

Databases

Online businesses need to access, store, retrieve, amend, and generate data in a wide variety of formats. A database is defined as a collection of information that is organised so that the required information can be quickly retrieved, amended if necessary, and then the electronic image updated. There are a number of proprietary database management systems that can provide the necessary functionality – and operate in a real time processing environment, with high volumes – while maintaining security and availability.

Form design

An e-commerce enabled website must include mechanisms for customers to enter information such as their name, address, and credit card number. This information is then stored in a database. Website developers create forms for customers to complete. Most electronic forms comprise text boxes combined with drop-down lists to simplify tasks for the customer and to avoid transcription errors where possible.

Shopping carts and checkouts

Many online stores use the image of a shopping cart (or trolley) to characterise the online shopping process. The shopping cart is now considered a standard component of all online stores. A shopping cart records the ongoing results of the ordering process, generated from a database, and is effectively the interface between the customer and the database. In the browser, these results appear on a web page that is updated every time a customer adds an item to the cart. Shopping carts are usually set up so that the customer can view all details of the ongoing transaction on request, at any time. When all transactions are complete, the customer is invited to go to the checkout to complete the purchasing process.

The checkout is usually located on a secure server that protects customer payment information during its transmission. For small businesses, standard software modules can be bought in for the shopping cart and checkout processes. In such cases the payment process is routed to a secure server managed by a specialist company, eg PayPal.

Although a small number of products and services can be distributed electronically, most products need to be physically delivered. Once a commitment to purchase has been made, ensuring that distribution is controlled, speed and visibility are critical success factors for the online store. Most online stores offer a variety of shipping methods with different timescales and prices. Some online stores will choose shippers who have 'track and trace' monitoring procedures available online. Customers are provided with the identity of the shipping agent and a reference for their package. They can then track its progress.

Adapted from an article originally written by a member of the P3 examining team

Chapter 18 Internal audit

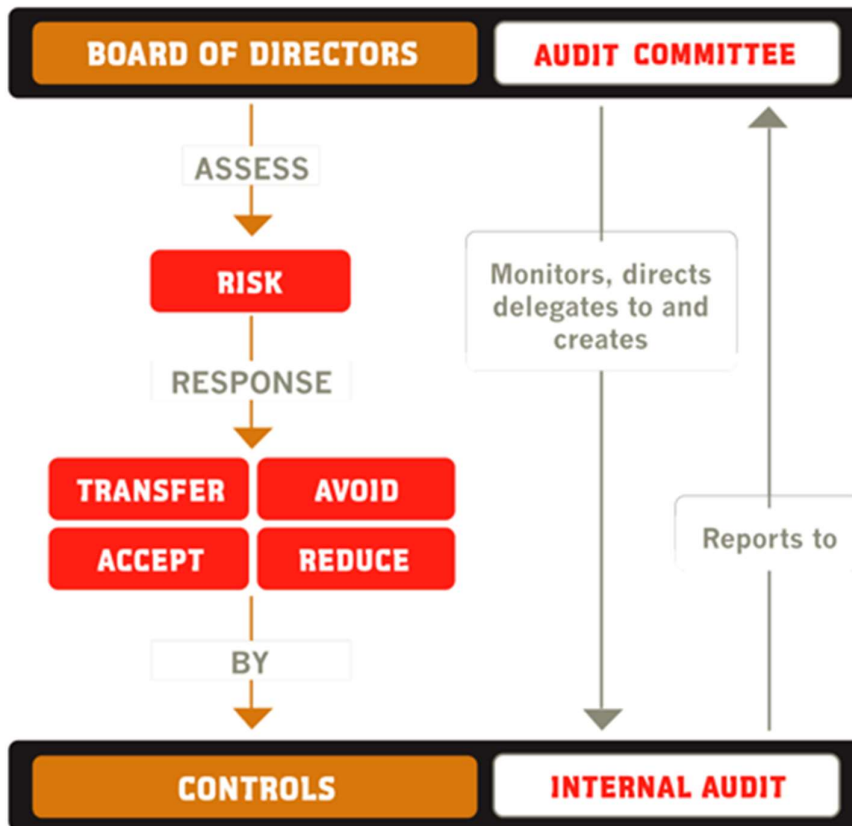
Executive Summary

Internal audit – the control of controls – can feature as a key part of the corporate governance framework of an organisation, and can be viewed as a high level control in response to risk or by considering the detailed work required of internal audit.

Introduction

Thinking about the internal audit (IA) function as the control of controls is useful for making sense of the way in which the topic appears in Strategic Business Leader (SBL). IA features in the SBL *Study Guide* in the section on internal control and review – specifically internal control, audit and compliance in corporate governance.

Think about how the topic of control arises when SBL covers the board of directors. It is best practice that ‘the board should maintain sound risk management and internal control systems’ and ‘should establish formal and transparent arrangements for considering how they should apply the corporate reporting and risk management and internal control principles’ (UK Corporate Governance Code). The detailed provisions of the code then specify that there should be an audit committee that ‘review[s] the company’s internal control and risk management systems’ and ‘should monitor and review the effectiveness of the internal audit activities’. It goes on to say that ‘where there is no internal audit function, the audit committee should consider annually whether there is a need for an internal audit function and make a recommendation to the board, and the reasons for the absence of such a function should be explained in the relevant section of the annual report’.



The internal audit function

Decision to have an internal audit department

At each stage of the process the board faces a number of decisions: setting the firm's risk appetite, assessing risks, and then choosing which risks to accept, transfer, reduce or avoid. If a risk reduction response is adopted, the board must then design an appropriate set of controls, possibly including establishing an internal audit function. In most jurisdictions, especially where corporate governance is principles-based, IA departments are not required by statute or regulation, but are considered best practice. However, as soon as the task of reviewing the company's internal control and risk management system reaches even a reasonably low level of complexity, the audit committee will find that they need to delegate this work. This is clearly a sensitive task, as it involves investigating and discovering how effective strategic and operational controls have been. It requires a skilled team of internal auditors, who can act independently and who will report back objectively to the audit committee. As you can imagine, it would be unusual for a company of any size

(not just a listed company) to be able to dispense with the services of an IA department, which is why an explanation is required when there are no internal auditors.

One obvious issue to consider is what other factors apart from size would indicate that an IA department might be required. It is not hard to come up with some of the relevant factors by reflecting that a company needs a control when risk needs reducing. So factors giving rise to increased risk, such as complex or highly regulated transactions, might suggest the need for the IA control to be deployed. You would, therefore, expect banks to have IA departments since some of the transactions they handle are complex (accounting for financial instruments) and they operate in a regulated industry.

In some regulated industries it is mandatory to have an internal audit department, but even where this is not the case there may be close scrutiny of the company by the regulatory authority, which can apply significant sanctions such as the removal of operating licences. When a compliance failing (including timely reporting to the regulator) might mean that the company cannot operate at all, the case for an internal audit department becomes overwhelming. Companies in regulated industries may also need the information from internal audit to use in their reports and submissions to regulators and, so, reliable and accurate IA information is also needed to ensure the adequacy of this reporting.

The UK's influential Turnbull report provides some other suggestions for the factors that ought to be considered when considering the establishment of an IA function. Some of them are things that might indicate risks. For example, one factor – number of employees – might indicate risks directly (a large volume of payroll transactions to process) but, more significantly, it indicates size and complexity, so perhaps widespread locations with complex reporting lines and less shared culture (of risk awareness, or of integrity). Specific problems with internal controls and an increase in unacceptable events are two other factors that might also be indicative of deeper issues within the organisation. As well as an immediate problem that needs investigating, both suggest failings in the board-implemented process of risk assessment and risk response, which – had it been done more effectively – might have implied the need for an IA department.

Arising out of uncertainty, risk is fundamental to change. Any significant changes faced by the business will therefore inevitably create risk, and the organisation should consider its need for internal audit. The changes highlighted in the Turnbull report are changes in key risks and changes in the internal organisational structure.

Table 1: The Turnbull criteria to assess the need for internal audit

Scale, diversity and complexity of the company's operations

Number of employees

Cost-benefit considerations

Changes in organisational structure

Changes in key risks

Problems with internal control systems

Increased number of unexplained or unacceptable events

Reporting to the audit committee

Let's return to the idea that the internal audit department is carrying out the delegated work of the audit committee. This is a fruitful area to explore because it explains some of the characteristics of effective (and ineffective) IA. The audit committee is made up of independent non-executive directors (NEDs). This isn't the place to explore the concept of independence in detail, but independence is central to an effective IA department. The work of IA becomes meaningless if it is compromised by management influence. Achieving independence is difficult, and made more so because internal auditors are usually employees of the company.

The audit committee is one of the vital parts of the committee structure of sound corporate governance. Its role in overseeing IA is important because it is the audit committee that ensures that the IA function actually supports the strategic objectives of the company (and doesn't act purely on its own initiative). In addition, though, it is likely that the audit committee – at the strategic level – will not only provide the IA function with the authority it needs to scrutinise the internal controls, but also to ensure that its work is actually supporting and providing the compliance needs of the company. It is part of ensuring the hierarchical congruence or consistency necessary in sound governance and strategic management.

Members of the IA function may encounter ethical threats (such as familiarity, self-review, independence threats, and so on). An accountant working as an internal auditor, for example, may be unwilling to criticise the CFO if he believes the CFO has an influence on his future prospects with the company. Someone coming into IA from an operational position could also be exposed to a self-review threat. Even where external contractors are used to carry out the IA function, they are acting on behalf of management. To avoid this, and other ethical threats, internal audit work is one of the jobs expressly forbidden to external auditors under the terms of the Sarbanes–Oxley Act in the US, indicating just how valuable a characteristic independence is for all auditors (other codes have similar provisions).

There are some inherent limitations in what an IA department can achieve. Although corporate scandals sometimes arise from failings in operational level controls, there are also examples where the problem is a failure of strategic level controls, either arising from management override of controls (as at Enron) or through poor strategic level decisions (as at some of the banks that required state support in the 2008 banking crisis). Even in companies where excellent procedures are put in place to assess operational level controls, it is hard to imagine how IA can fully monitor strategic controls. It would be very hard to design a corporate governance structure in which even the most independent IA

department had a mechanism to do much more than check that procedures have been followed at board level. The board ultimately has to be responsible for the proper working of strategic level controls. This is also illustrative of the way IA fits in to overall corporate governance. The corporate governance big picture has to be addressed if IA is going to be effective. A domineering CEO cannot be countered by the existence of an IA department. Indeed, interference in the work of internal audit would indicate broader corporate governance problems.

Day-to-day internal audit

In the Audit and Assurance (AA) exam, you will have studied the types of work carried out by internal auditors:

- value for money audits
- information technology audits
- best value audits
- financial audits
- operational audits.

One of the key differences between internal and external audit is that the scope of internal audit work in an unregulated industry is determined by the company (specifically by the audit committee) while the scope of the external auditors' work is determined by the fact that they are undertaking a statutory audit, a legal requirement. IA will mean something different in each organisation. In one company, the 'internal audit' department might only carry out quality control checks, while in another it is a sophisticated team of specialists with different expertise that reflect the risks faced by that organization, including the regulatory requirements placed upon it.

Whether the IA department is carrying out a review of the process of designing systems, or a review of the operation of controls within those systems, will depend on the current concerns of the organisation. In an exam it would be wise to tailor the suggestions made for IA to the concerns hinted at in the scenario. For example, in a highly regulated business where compliance failures are a significant risk, monitoring compliance might be a key task assigned to IA. If safeguarding assets is a key concern you could discuss how IA might be involved in a review of the safeguarding of assets. You may have noted that the last two suggestions both relate to the Turnbull statements about a sound system of internal

controls. Any of those could be related to the work of internal audit – for example, IA might need to review the implementation of corporate objectives.

SBL also covers issues of sustainability, environmental and social responsibility. IA is a resource that could be deployed to monitor how effective a company's corporate social responsibility (CSR) policies are. This could mean monitoring how well the policies have been implemented or it could mean IA monitoring how well CSR policies and wider corporate objectives are aligned with each other. Schemes like the European Union's Eco-Management and Audit Scheme (EMAS) provide an example of an instance where specific monitoring of targets (by IA) is an externally imposed requirement on a company. ISO 14000, another environmental standard, also explicitly requires internal audits and reports to management.

To sum up, internal audit is the control of controls. It can feature in SBL as a key part of the corporate governance framework of an organisation, and it can be viewed through the lens of risk management as a high level control in response to risk or by considering the detailed work required of IA. Finally, as a key component of the control system, it is important to maintain the integrity of internal audit and, from this perspective, issues of professional ethics and characteristics such as independence come into play.

Adapted from an article originally written for P1 by Amanda Williams (a tutor and subject specialist at BPP Professional Education)

Chapter 19 Risk and environmental auditing

Executive Summary

Risk auditing and social and environmental auditing are widely adopted and are increasingly being employed by organisations to increase investor confidence and respond to other stakeholder demands.

What is risk?

We all have an intuitive idea of risk. A good working definition of risk is an unrealised future loss arising from a present action or inaction. If I risk \$1 on a lottery ticket in the hope that I might win the jackpot of several million dollars, there is a high probability that a presently unrealised loss will materialise (ie, I won't win the lottery). I will probably not win and therefore my \$1 investment will be lost. Conversely, if I risk my \$1 buying a share in a well-established large public company, there is less overall probability of losing my entire dollar (although I may lose a part of the value) but at the same time, the expected returns on the share purchase are likely to be much less than my maximum possible return on my lottery ticket.

Return is, on average, a function of risk. 'Risky' share funds are those with the largest number of possible outcomes but with the possibility of higher returns should the best scenario be played out (such as investing in SMEs and small, growing companies).

In SBL we consider risk as a subject in itself but we also look at how risk is associated with internal activities. It is because of this that risk management is an important part of the management of internal controls, controls which are, in turn, a crucial part of corporate governance. As we have sadly seen on many occasions in the past, internal controls can fail to adequately control risks and it is for this reason that it is crucial that an organisation understands and can quantify the risks that it faces.

Internal and external risk audit

Risk audit and assessment is a systematic way of understanding the risks that an organisation faces. Because the range and types of risks are many and varied, risk assessment and audit can be a complicated and involved process. Some organisations, such as large financial services providers, employ teams of people whose job it is to continually monitor and internally report on the organisation's risks. For others, the activity is only undertaken occasionally, perhaps as a part of the annual cycle of internal control management. Unlike financial auditing, risk audit is not a mandatory requirement for all organisations but, importantly, in some highly regulated industries (such as banking and financial services), a form of ongoing risk assessment and audit is compulsory in most jurisdictions. Some organisations employ internal risk specialists to carry out risk auditing 'in house', but in other cases, the role is undertaken by external consultants. There are pros and cons of both approaches.

Risk audit as an internal function has the advantage that those conducting the audit are likely to be highly familiar with the organisation, its systems, procedures, regulatory environment, and culture. By understanding how things 'work' (who does what, what regulations apply and where), and also understanding relevant technical matters, legal frameworks and control systems, an internal auditor should be able to carry out a highly context-specific risk audit. The audit is likely to contain assessments that are written and structured according to the expectations and norms of the organisation, perhaps using appropriate technical language and in a form specifically intended for that particular organisation's management.

The disadvantages are the threats of impaired independence and overfamiliarity that are present in many internal audit situations. It is to avoid these that many organisations prefer to have risk audit and assessment carried out by external parties.

Having an external risk audit brings a number of advantages. First, it reduces or avoids the independence and familiarity threats. It is likely that external auditors will have no link to anybody inside the organisation being audited and so there will be fewer prior friendships and personal relationships to consider.

Second, the fact that these threats are avoided or reduced will create a higher degree of confidence for investors and, where applicable, regulators.

Third, any external auditor brings a fresh pair of eyes to the task, identifying issues that internal auditors may have overlooked because of familiarity. When internal employees audit a system or department, they may be so familiar with the organisation's routines, procedures, culture, and norms that a key risk might be overlooked or wrongly assessed.

Fourth, best practice and current developments can be introduced if external consultants are aware of these. Given that consultants typically promote themselves on the currency of their skills, it is often more likely that their knowledge will be more up to date than that of internal staff, whose skills may be geared specifically to their organisation's needs and expectations.

What is involved in risk audit?

There are four stages in any risk audit (internal or external): identify, assess, review, and report. Together, these comprise an audit or review of the risk management of an organisation.

Identification

Given the range of potential unrealised losses that an organisation might face, it would be inexcusable for management to be ignorant of what the risks are, so identification of risks is the first part of any risk audit. Risks come and go with the changing nature of business activity, and with the continual change in any organisation's environment. New risks emerge and old ones disappear. Identification is therefore particularly important for those organisations existing in turbulent environments. Uncertainty can come from any of the political, economic, natural, socio-demographic or technological contexts in which the organisation operates.

Assessment

Once identified, the next task is to assess the risk. Each identified risk needs to be measured against two variables: the probability (or likelihood) of the risk being realised; and the impact or hazard (what would happen if the risk was realised). These two intersecting continua can be used to create a probability/impact grid on to which individual risks can theoretically be plotted. I say 'theoretically' because it is sometimes not possible to gain enough information about a risk to gain an accurate picture of its impact and/or probability.

This assessment strategy is used in many situations, from share portfolio management to terrorism prevention, and to understand the effects of risks on internationalisation strategies. In anti-terrorism planning, for example, governments assess certain potential 'big ticket' terrorist attacks as 'high impact but low probability' events, and other attacks as the opposite. If this were an article on risk management, I would now go on to discuss the risk strategies of 'transfer' (or share), 'avoid', 'reduce' and 'accept', but instead, in a risk audit, the auditor goes on to review the organisation's responses to each identified and assessed risk.

Review

At the review stage, the auditor analyses the controls that the organisation has in the event of the risk materialising. For example, this could involve looking at insurance cover where appropriate, the extent to which the risk portfolio is diversified, and any other controls appropriate to the risk. In the case of accepted risks, a review is undertaken of the effectiveness of planning for measures such as evacuation, clean-up and so on, should the unavoidable risk materialise. Review can represent a substantial task, as the response to each assessed risk is a part of the review and there may be many risks to consider.

Report

Finally, a report on the review is produced and submitted to the principal which, in most

cases, is the Board of the organisation that commissioned the audit. Management will probably want to know about the extent of the key risks (those with high probability, high impact, and especially both high impact and high probability); the quality of existing assessment; and the effectiveness of controls currently in place. Clearly, any ineffective controls will be a key component of the report and they would be the subject of urgent management attention.

Social and environmental audit: why?

One area of audit activity that has grown in recent years is that of social and environmental audit. The social and environmental accounting 'movement' began in the mid-1980s, when it was first coherently argued that there was a moral case for businesses, in addition to reporting on their use of shareholders' funds, to account for their impact on social and natural environments. While accounting instruments already existed for reporting financial performance, there weren't any for accounting for non-costable impacts, and it was this that gave rise to modern social and environmental accounting.

If, for example, a meat processor buys in beef and processes it for onward sale (eg as burgers), then the cost of the beef includes all of the identifiable costs incurred by the supply chain up to that point (plus profit margins, of course). So for beef, those costs will include elements of farming, land costs, logistical costs, abattoir costs, and so on. However, the farmer who produced the beef may have reared the cattle on land bought as a result of forest clearance. He may have paid a market price for the land upon which to graze his cattle, but the initial deforestation has implications that could not have been factored into the price he paid for the land. How, for example, could you attribute a cost to the loss of species habitat or the loss of greenhouse gas processing capacity? It is because of the difficulties in allocating the costs of these externalities that, environmental activists say, the price of that beef does not reflect the true – or full – cost, which should include the cost to the environment. The same would apply to almost any product of course, not just beef. In the case of oil and gas, for example, the environmental footprint includes the extraction of a non-renewable energy source and the release of greenhouse gases (carbon and sulphur-based gases) into the environment.

What has all this got to do with audit? It is important because, increasingly, many investors and other stakeholders want to know about an organisation's environmental footprint in addition to its economic performance. Typically, there are three sources of pressure for this:

- There is a growing belief that environmental issues represent a source of risk in terms of unforeseen (or foreseen) liabilities, reputational damage, or similar.
- The ethical performance of a business, such as its social and environmental behaviour, is a factor in some people's decision to engage with the business in its resource and product markets. This means, for example, that some consumers will not buy from companies with unfavourable ethical reputations (ie in product markets) and, in resource markets, potential employees may use ethical performance as a criterion in their choice of potential employer.
- An increasing number of investors are using social and environmental performance as a key criterion for their investment decisions. While this has been a factor in ethical funds since they first appeared in the early 1980s, ethical concern has become more 'mainstream' in recent years.

Environmental audit: what?

An environmental audit, and the production of an environmental report, enables an organisation to demonstrate its responsiveness to all the sources of concern outlined above. Except in some highly regulated situations (such as water), the production of an environmental audit is voluntary. The production of such a report, however, ensures that an organisation has systems in place for the collection of data that can also be used in its environmental reporting.

An environmental audit typically contains three elements: agreed metrics (what should be measured and how), performance measured against those metrics, and reporting on the levels of compliance or variance. The problem, however, and the subject of most debate, is what to measure and how to measure it. As an environmental audit isn't compulsory, there are no mandatory audit standards and no compulsory auditable activities. So an organisation can engage with a social and environmental audit at any level it chooses (excepting those in regulated industries for which it is mandatory). Frameworks do exist, such as the data-gathering tools for the Global Reporting Initiative (GRI), AA1000, and the ISO 14000 collection of standards, but essentially there is no underpinning compulsion to any of it.

This does not mean that it is entirely voluntary, however, as stakeholder pressure demands it in some situations. Most large organisations in developed countries collect a great deal of environmental data, many have environmental audit systems in place, and almost all produce an annual environmental report. Some organisations audit internally and others

employ external auditors, partly to increase the credibility of the audit and partly because of a lack of internal competence.

In practice, the metrics used in an environmental audit tend to be context specific and somewhat contested. Typical measures, however, include measures of emissions (eg pollution, waste and greenhouse gases) and consumption (eg of energy, water, non-renewable feedstocks). Together, these comprise the organisation's environmental footprint. Some organisations have a very large footprint, producing substantial emissions and consuming high levels of energy and feedstocks, while others have a lower footprint. One of the assumptions of environmental management is that the reduction of footprint is desirable, or possibly of 'unit footprint': the footprint attributable to each unit of output. If a target is set for each of these then clearly a variance can be calculated against the target. Some organisations report this data – others do not. It is this ability to pick and choose that makes voluntary adoption so controversial in some circles.

A recent trend, however, is to adopt a more quantitative approach to the social and environmental audit. The data gathered from the audit enables metrics to be reported against target or trend (or both). It is generally agreed that this level of detail in the report helps readers better understand the environmental performance of organisations.

Summary

Audit and assurance is a concept that extends beyond statutory financial audit. In addition to the widespread use of internal audit, risk auditing and social and environmental auditing are widely adopted and are increasingly being employed by organisations to increase investor confidence and respond to other stakeholder demands. In some cases, these are an integral part of internal control, but in other situations, they are standalone activities. In both cases, the reports are based on the assessments produced by the auditors. In the case of social and environmental auditing, in addition to providing management information, the data might also be used to provide content for external environmental reporting.

Unlike financial audit and assurance, a lack of mandatory standards means that the value of these audits is disputed, but it is generally agreed that more knowledge and information on any aspect of governance is better than less.

Adapted from an article originally written by a member of the P1 examining team

Chapter 20 Performance appraisal

Executive Summary

Performance appraisal requires good interpretation and a good understanding of what the information means in the context of the question.

Introduction

Performance appraisal is an important aspect of the Financial Reporting (FR) exam and of interest to Strategic Business Leader candidates. At this level you are not only required to prepare financial statements but understand the information underpinning the results.

You will often be required to make use of ratios to aid interpretation of the financial statements for the current year and to compare them to the results of a prior period, another entity, or against industry averages.

Increasingly, candidate exam performance is demonstrating a lack of commercial awareness and knowledge that barely stretches past the 'rote learned' phase. Candidates regularly state facts such as 'gross profit margin has increased' or, 'payables days have gone down' but this offers no interpretation of the reason behind the change in ratio. As a result markers find it difficult to award sufficient marks to candidates to achieve a pass.

This article is designed to aid candidates in understanding what is expected to create a solid answer to a performance appraisal question.

Specific problems

When marking this style of question there are some common weaknesses that are identified, some of which are highlighted below:

- limited knowledge of ratio calculations
- appraisal not linked to scenario
- poor understanding of the topic
- limited understanding of what accounting information represents
- lack of commercial awareness
- discursive elements often not attempted
- inability to come to a conclusion
- poor handwriting (often illegible in some instances)
- poor English.

Use the scenario

The majority of questions that feature in Question 3 have an accompanying scenario to the question requirement. A weak answer will make no attempt to refer to this information in the appraisal and, therefore, will often score few marks. It is important that you carefully consider this information and incorporate it into your appraisal because it has been provided for a reason. Do not simply list all the possibilities of why a ratio may have changed; link the reason to the scenario that you have been provided with.

Example

The question scenario may provide you with a set of financial statements and some further information such as details of non-current assets (potentially including a revaluation, a major acquisition or disposal) or measures undertaken during the year in an attempt to improve performance. When constructing your answer you must consider the effect that information such as this would have on the company results.

A major asset disposal would most likely have a significant impact on a company's financial statements in that it would result in a profit or loss on disposal being taken to the statement of profit or loss and a cash injection being received. It is worth noting that while the current year results will be affected by this, it is a one-off adjustment and bears little resemblance to future periods. When calculating ratios the disposal will improve asset turnover as the asset base becomes smaller over which revenue is spread and will, therefore, also improve return on capital employed. The operating margin is likely to be affected also as the profit or loss on disposal will be included when calculating this.

It is often worth calculating some of the results again (eg ROCE or operating profit margin) as part of your interpretation without the one-off disposal information, as arguably this will help make the information more comparable to the results that do not include such disposals (if time is limited a comment about the disposal's effect will be sufficient).

From a liquidity point of view the cash received on disposal of the asset will have aided cash flow during the year - ask yourself what would have happened if the company had not received this cash - ie are they already operating on an overdraft? If so, the cash flow position would be far worse without the disposal cash.

If a revaluation of non-current assets has taken place during the year the capital employed base will grow – this will have the impact of reducing both the asset turnover and return on capital employed ratios without any real change in operating capacity or profitability.

A major asset purchase again would cause both asset turnover and return on capital employed to deteriorate as the capital employed base would grow. It may appear that as a result of the acquisition the company has become less efficient at generating revenue and profit but this may not always be the case.

If, for example, the purchase took place during the latter half of the year, the new asset will not have contributed to a full year's profit and it may be that in future periods the business will begin to see a better return as a result of the investment. When analysing the performance and position of the company, if management have implemented measures during the year to improve performance it is worth considering whether or not these measures have actually been effective. If, for example, a company chose to give rebates to customers for orders above a set quantity level - this would have the impact of improving revenue at the sacrifice of gross profit margin.

Know the basics

Ratios can generally be broken down into several key areas: profitability, liquidity, gearing and investment. As a candidate taking the FR exam you need to know the formulae for the relevant ratios and also what movements in these ratios could possibly mean. Provided below is a brief overview of the key ratios and what movements could indicate – further clarification and understanding can be found through your study text and then by practising past questions (due to the limited space of this article, investment ratios will not be discussed but this does not make them any less important).

Profitability

Return on capital employed (ROCE)

Profit before interest and tax

Shareholders' equity + debt

Got it Pass eLearning Co**Supplementary Notes**

This ratio is generally considered to be the primary profitability ratio as it shows how well a business has generated profit from its long-term financing. An increase in ROCE is generally considered to be an improvement.

Movements in return on capital employed are best interpreted by examining profit margins and asset turnover in more detail (often referred to as the secondary ratios) as ROCE is made up of these component parts. For example, an improvement in ROCE could be due to an improvement in margins or more efficient use of assets.

Asset turnover

$$\frac{\text{Revenue}}{\text{Total assets - current liabilities}}$$

Asset turnover shows how efficiently management have utilised assets to generate revenue. When looking at the components of the ratio a change will be linked to either a movement in revenue, a movement in net assets, or both.

There are many factors that could both improve and deteriorate asset turnover. For example, a significant increase in sales revenue would contribute to an increase in asset turnover or, if the business enters into a sale and operating lease agreement, then the asset base would become smaller, thus improving the result.

Profit margins

$$\frac{\text{Gross or Operating profit}}{\text{Revenue}}$$

The gross profit margin looks at the performance of the business at the direct trading level. Typically variations in this ratio are as a result of changes in the selling price/sales volume or changes in cost of sales. For example, cost of sales may include inventory write downs that may have occurred during the period due to damage or obsolescence, exchange rate fluctuations or import duties.

The operating profit margin (or net profit margin) is generally calculated by comparing the profit before interest and tax of a business to revenue, but, beware in the exam as sometimes the examiner specifically requests the calculation to include profit before tax.

Analysing the operating profit margin enables you to determine how well the business has managed to control its indirect costs during the period. In the exam when interpreting operating profit margin it is advisable to link the result back to the gross profit margin. For example, if gross profit margin deteriorated in the year then it would be expected that operating margin would also fall.

However, if this is not the case, or the fall is not so severe, it may be due to good indirect cost control or perhaps there could be a one-off profit on disposal distorting the operating profit figure.

Liquidity

Current ratio

$$\frac{\text{Current assets}}{\text{Current liabilities}}$$

The current ratio considers how well a business can cover the current liabilities with its current assets. It is a common belief that the ideal for this ratio is between 1.5 and 2 to 1 so that a business may comfortably cover its current liabilities should they fall due.

However this ideal will vary from industry to industry. For example, a business in the service industry would have little or no inventory and therefore could have a current ratio of less than 1. This does not necessarily mean that it has liquidity problems so it is better to compare the result to previous years or industry averages.

Quick ratio (sometimes referred to as acid test ratio)

$$\frac{\text{Current assets - inventory}}{\text{Current liabilities}}$$

The quick ratio excludes inventory as it takes longer to turn into cash and therefore places emphasis on the business's 'quick assets' and whether or not these are sufficient to cover the current liabilities. Here the ideal ratio is thought to be 1:1 but as with the current ratio, this will vary depending on the industry in which the business operates.

When assessing both the current and the quick ratios, look at the information provided within the question to consider whether or not the company is overdrawn at the year-end. The overdraft is an additional factor indicating potential liquidity problems and this form of finance is both expensive (higher rates of interest) and risky (repayable on demand).

Receivables collection period (in days)

$$\frac{\text{Receivables}}{\text{Credit sales}} \times 365$$

It is preferable to have a short credit period for receivables as this will aid a business's cash flow. However, some businesses base their strategy on long credit periods. For example, a business that sells sofas might offer a long credit period to achieve higher sales and be more competitive than similar entities offering shorter credit periods.

If the receivables days are shorter compared to the prior period it could indicate better credit control or potential settlement discounts being offered to collect cash more quickly whereas an increase in credit periods could indicate a deterioration in credit control or potential bad debts.

Payables collection period (in days)

$$\frac{\text{Payables}}{\text{Credit purchases}^*} \times 365$$

*(or cost of sales if not available)

An increase in payables days could indicate that a business is having cash flow difficulties and is therefore delaying payments using suppliers as a free source of finance. It is important that a business pays within the agreed credit period to avoid conflict with suppliers. If the payables days are reducing this indicates suppliers are being paid more quickly. This could be due to credit terms being tightened or taking advantage of early settlement discounts being offered.

Inventory days

$$\frac{\text{Closing (or average) inventory}}{\text{Cost of sales}} \times 365$$

Generally the lower the number of days that inventory is held the better as holding inventory for long periods of time constrains cash flow and increases the risk associated with holding the inventory. The longer inventory is held the greater the risk that it could be subject to theft, damage or obsolescence. However, a business should always ensure that there is sufficient inventory to meet the demand of its customers.

Gearing

$$\frac{\text{Debt}}{\text{Equity}} \quad \text{or} \quad \frac{\text{Debt}}{\text{Debt} + \text{equity}}$$

The gearing ratio is of particular importance to a business as it indicates how risky a business is perceived to be based on its level of borrowing. As borrowing increases so does the risk as the business is now liable to not only repay the debt but meet any interest commitments under it. In addition, to raise further debt finance could potentially be more difficult and more expensive.

If a company has a high level of gearing it does not necessarily mean that it will face difficulties as a result of this. For example, if the business has a high level of security in the form of tangible non-current assets and can comfortably cover its interest payments (interest cover = profit before interest and tax compared to interest) a high level of gearing should not give an investor cause for concern.

Conclusion

In the exam make sure all calculations required are attempted so that you can offer possible reasons for any change in the discussion part of the question.

There is no absolute correct answer to a performance appraisal question. What sets a good answer apart from a poor one is the discussion of possible reasons for why (specifically in the given scenario) changes in the ratios may have occurred.

Adapted from an article originally written by Bobbie Retallack (a Kaplan Publishing's content specialist for the FR exam)

Chapter 21 Blockchain: a revolution in the making

Executive Summary

Blockchain is a term that many people have heard about, but very few still fully understand.

Blockchain is a term that many people have heard about, but very few still fully understand. However, this amazing innovative technology is going to revolutionise the business world by radically changing the whole idea of controlling secure transactions and information management.

Blockchain – what is all the fuss about?

The blockchain concept has been attributed to Satoshi Nakamoto, which is a pseudonym for the person or persons who developed the technology in 2008. The first blockchain created was designed to support the introduction of the digital bitcoin cryptocurrency, by providing a secure record of every bitcoin transaction without the need for a bank or financial intermediary. However, over the last decade the use of blockchains in business has had wide reaching impacts way beyond recording basic financial transactions.

Blockchain technology is now used to record all sorts of information ranging from medical records to the processing of passport applications. Blockchains enhance business efficiency because they eliminate duplication of effort, and reduce the need for costly intermediaries.

So, what exactly is a blockchain?

Put quite simply a blockchain is an immutable digital ledger that can record managed transactions and tracks assets over a decentralised network. Pretty much any item of value can be traded, transferred and tracked using a blockchain, which reduces both inherent risks and costs for all concerned. The assets could be tangible, such as property, or intangible like an identity.

In practical terms a blockchain stores information across a network of distributed computers; with no one person owning the system, but anyone can use it and help to operate it. As a result, it is incredibly difficult for any single person to edit a block, corrupt the information or take down the blockchain.

Unlike business systems, where it is the norm for one central database to be the secure repository of all business data and information with a central processor, blockchain

technology requires that all blocks of data are stored on every single computer in the blockchain. The security that this builds into a blockchain system is enabled through the peer-to-peer network configuration, with the resultant block data storage managed autonomously and in a decentralised way.

The blockchain architecture allows all participants the ability to share a block that is synchronised through peer-to-peer replication each time a transaction occurs. This approach means that each participant in the network acts as both a contributor of, and a subscriber to, all of the information contained within it. Each participant is able to receive or send transactions to others by adding blocks, and the data is automatically synchronized across the whole blockchain as it's transferred.

The key features of a blockchain

A blockchain has a number of distinct features that differentiates it from more traditional transaction processing systems:

- **Single source:** the shared blockchain ledger provides participants with one place to determine the completion of a transaction, or the ownership of an asset.
- **Consensus:** for any single blockchain transaction to be valid, all participants must agree on its validity.
- **Origin:** all participants know where any asset originates from, and how its ownership may have changed over time.
- **Integrity:** No participant can meddle with a transaction after it has been recorded to the blockchain ledger. Indeed, should a transaction be recorded incorrectly or in error, a further transaction must be added to the blockchain to contra the entry, with both transactions visible to all participants.

All of these features make a blockchain unique and incredibly secure.

How is a blockchain so incredibly secure?

There are three elements that contribute to blockchain security

1. Before a block of information can be added to the blockchain it must have its own unique digital finger print, called a hash, together with the hash to the previous block. The hash is a unique cryptographic code that identifies a block and all of its contents. Therefore, any attempt to change the block content will change the hash, so it will be no longer validated as part of the chain.
2. A blockchain requires 'proof of work', which is an algorithm used to confirm transactions and produce new blocks to the chain. This process has the effect of slowing down the creation of a new block for several minutes. Therefore, it would very hard to tamper with the content of a block as it would require changing the proof of work for all subsequently blocks in the chain, which can run to many thousands. This would not go unnoticed because of the time involved.
3. Distributed peer to peer networks is synchronised. They all hold a copy of the chain and each user, sometimes called a node, has to verify the block and then add it to the chain. To compromise the integrity of the blockchain would require that all nodes consent to do exactly the same actions at the same time, which is quite impossible as they are all acting independently and transparently.

The future of blockchain

The wide application of blockchain technology is not going to be limited to digital currency in the finance industry. It has a strong future in a many different business sectors ranging from smart contracts in supply chain management to digital advertising and the Internet of things.

Some governments have really embraced blockchain technology. Estonia, for example, has been testing the benefits of blockchain for over a decade and it is now a key feature of Estonian data registries for legislative, healthcare, and banking purposes. Despite blockchain technology being capable of yielding tremendous benefits, not all global nations are at the same point with regard to adopting it. There are countries that have been more accepting of the technological change this particular technology can provide, while others are lagging behind.

It should be highlighted that, while global nations are generally open to the decentralized database technology, their stances may differ on cryptocurrency use regulation. National regulators are working on the means of handling the technology and drafting suitable regulations so as to not obstruct its progress, and to cultivate the social impact of blockchain technology.

How could blockchain technology be applied in Strategic Business Leader (SBL)?

An SBL examination might require a candidate to analyse a situation where an organisation of some kind may have had its information systems or databases infiltrated or hacked, or there may be a situation where customers or clients complain that their records are not visible to them and the company may experience reputational damage for not being sufficiently transparent with its stakeholders. All or part of the solution might be to recommend the implementation of blockchain with justifications.

For example, if blockchain technology were to be applied to medical records, the benefits of doing so would be that past records could never be altered by anyone and be completely inaccessible to anyone other than the person with whom the record is associated, such as the individual patient and/or their own doctor. Although patients would be allowed to independently access their own past and current records, for transparency reasons, they could never change or alter any record of their own or access anyone else's medical record or change them in any way. Only the medical practitioners with the authority to, could access and create new records for their own patients and would be able to add to, but not make any changes to the existing records.

Written by a member of the Strategic Business Leader examining team

Chapter 22 Cryptocurrencies and initial coin offerings (ICOs)**Executive Summary**

This article looks at what exactly cryptocurrencies are, the potential impact of this disruptive technology, and their application as a source of short and long-term finance.

Financial technology, or Fintech, is powerful new technology that has the potential to revolutionise the work of accountants by improving and automating the ways in which financial services are used and delivered.

One of the most well-known applications of Fintech is the development and use of cryptocurrencies. The arrival of Bitcoin, and the subsequent high financial gains that were quickly made by some of those involved, generated significant media attention.

In this article we will take a look at what exactly cryptocurrencies are, the potential impact of this disruptive technology, and their application as a source of short and long-term finance.

Digital assets

Essentially, a cryptocurrency is a digital asset. While it works in a similar way to traditional currencies, it has no physical form and exists solely as digital code.

In order to be considered an asset, digital assets must offer the holder the right to use. In a cryptocurrency system, the holders of the digital code (cryptocurrency units) have the right to use or exchange that data, either for other digital assets (ie units of a different cryptocurrency) or more traditional items such as goods or services.

On the face of it, this exchange is very similar to the use of money in a traditional fiat currency system, however the way that cryptocurrencies operate is very different.

Distributed ledger

Fiat currencies operate through a central banking system. The central records are held at the central bank, transactions are carried out and authorised by the bank clearing system using manual processes, and the bank oversees and takes ultimate responsibility for that currency.

In a cryptocurrency system, there is no central bank, no central records, and no central authority. It is operated instead using a distributed ledger system.

A distributed ledger is, in effect, a huge database of which there is no single definitive version. The ledger is instead 'distributed' meaning that it is multiplied and held on every computer that is connected to the cryptocurrency network. When a change is made, such as a transaction taking place between two users of the cryptocurrency, the transaction will be authorised, not by a bank or other centralised authority, but by a consensus mechanism carried out by the network connected to the ledger. Once approved, every single copy of the ledger, on every single computer is updated to reflect the change.

This presents a clear advantage over the traditional banking system in which central records could be hacked and manipulated. To successfully manipulate a distributed ledger system every single copy of the ledger would need to be hacked and altered; a near impossible task.

Benefits of cryptocurrencies

The decentralised network on which cryptocurrencies operate means that cryptocurrency, unlike fiat currency, is not regulated nor reliant on a central bank (which may collapse) or government (which may become unstable). This offers several benefits:

- Reduced currency risk
- Avoidance of bank or regulator transaction fees
- Easier business transactions with wider range of domestic and international users
- Cryptocurrencies could also potentially offer a more stable currency to locations with unstable local currencies

Limitations

However, cryptocurrencies are still an emerging area and to date they remain largely unregulated.

The extent to which regulations are in place also varies significantly around the world. For example, in China cryptocurrency exchanges are illegal and regulation is harsh. Japan on the other hand has a progressive regulatory environment for cryptocurrencies and they are considered legal tender. In the United States, laws and regulations vary from state to state, meaning there is no consistent approach in the country itself.

The UK, like the majority of countries, does not class cryptocurrencies as legal tender and they are not governed by any specific laws. However, exchanges are legal and the registration requirements of the Financial Conduct Authority (FCA) must be complied with.

This low regulatory environment, combined with the relative anonymity afforded by the blockchain technology on which cryptocurrencies are built, presents serious risks, including:

- Lack of accountability as there is no one to govern the system. Law enforcement is challenging as a result.
- The lack of a central authority also means a lack of consumer protection, for example there will be no collective deposit insurance scheme to reimburse investors who lose funds due to hacking.
- Investors may lose their funds if their password is lost. This is because users are identified in the system using keys rather than personal data. This makes it much harder, and sometimes impossible, to confirm identity.
- Increased risk of tax evasion as cryptocurrency transactions take place outside the formal banking system. The current generation of cryptocurrencies are complex and difficult to track, making cryptocurrency transactions much harder to account for, increasing the ease with which they can be omitted from taxable income reports.
- Due to the high levels of confidentiality afforded to users, along with the challenges of tracking transactions, cryptocurrencies can facilitate illicit activity, such as money laundering or illegal drug transactions

Despite these limitations, cryptocurrency use continues to rise.

Cryptocurrencies as a means of exchange:

Cryptocurrencies can be used in a similar way as cash for the payment for goods and services. However, not only are they are not widely accepted by retailers they are volatile and as such an unreliable store of value.

In most locations globally, cryptocurrencies are not legal tender and considered to be neither money, nor a currency.

However, the use of cryptocurrencies as a medium of exchange offers some benefits, for example transactions can be carried out much faster, and at lower cost, due to the involvement of fewer intermediaries. The lack of a central system also means the risk of outages is greatly reduced resulting in a more stable platform for transactions.

The use of cryptocurrencies in this way is now declining as users move increasingly towards holding cryptocurrencies as an investment.

Cryptocurrency investments:

At present, the biggest use of cryptocurrencies is an investment, with many attracted by the widely publicised high gains made by others, such as during the Bitcoin bubble of 2017.

Cryptocurrencies are traded on exchanges, similar to those used for trading stocks and shares and offer the possible benefit of widening access to new investment opportunities. However, the risk to which consumers may be exposed is significant, both due to the lack of regulation and the potential for loss, such as when the bubble 'burst' in early 2018. The relative anonymity of users also increases the risk that cryptocurrency investment will be used for money laundering or other financial crimes.

Initial coin offerings (ICOs):

Cryptocurrencies can also be used as a method of raising finance. This is achieved through the creation of a decentralised network in an ICO.

ICOs have a degree of similarity with Initial Public Offerings (IPOs) in mainstream investment. However, there are some key differences.

- Supporters, not investors: ICOs involve supporters who buy into the system. This is similar to the approach used in crowdfunding; however, while crowdfunding involves making donations, in an ICO the supporters receive a potential reward as a motivation to invest.
- There is no controlling authority to govern ICOs due to their decentralised nature.
- Unlike IPOs, ICOs are, in the most part, unregulated. This increases the potential for scam ICOs targeting under-informed investors drawn by the possibility of high returns

Originally, ICOs were used by tech entrepreneurs as a method of raising the finance they need to create a new blockchain-based cryptocurrency or related app or system.

Supporters buy-into the system, receiving tokens in the new currency in exchange. Unlike shares received in an IPO, the tokens in an ICO have no inherent value, however if the system was successful the tokens would become valuable. A number of successful ICOs have rewarded supporters with quick, large returns.

This niche approach to raising finance allows the company to raise funds very quickly, and to bypass the heavily regulated, lengthy processes associated with raising funds via a bank

or venture capitalist, making them very tempting, particularly to new companies in the technological sectors.

The popularity of ICOs soared in the latter half of 2017 at which time they overtook venture capital as the primary source of funding in the blockchain sector.

Suitability, Acceptability and Feasibility of ICOs as a source of finance:

Companies, particularly in the technological sector, may consider ICOs as a source of potential short or long term finance. The suitability, acceptability and feasibility of this option as opposed to traditional sources of finance for the company will depend on how aligned it is with the strategy and operations of the company.

When assessing this, the company will need to take into account the pros and cons of carrying out an ICO and consider the significance of these to their organisation.

Let's look first at what factors might draw companies towards using ICOs as a source of finance.

- **Money can be raised quickly.** ICOs allow a company to raise funds much faster than they could using a more conventional source of finance. This is likely to be appealing to a company that is at an early stage of start up as it would allow them to raise all the necessary funds straight away. The founders could then spend their time developing their product, rather than spending a lengthy period of time on fundraising activities. For this reason, they may consider an ICO to be *suitable* for such a company where there may not yet be many stakeholders beyond the founders, and so the speed with which money can be raised for the venture may also be a factor that influences the *acceptability* of ICOs as a source of finance.
- **Cheaper.** The lack of intermediaries in an ICO make them significantly cheaper than more traditional sources of finance as many of the settlement and transaction charges will be avoided. For a company who may struggle to raise the funds through conventional methods the ICO may be considered to be a more *feasible* financing route.
- **Ease.** The process is simple and there are few barriers to entry. Again, making ICOs a potentially more *feasible* source of finance, particularly for early-stage start up companies.
- **Global investor base.** ICOs are carried out exclusively online and are available to potential investors regardless of location. There are also no restrictions as to who can invest in the

ICO increasing the chances that investors will be found. These factors could be very appealing to companies based in countries in which there is limited access to venture capital perhaps making ICOs a more *feasible* source of finance.

- **Immediately liquid investments:** unlike in traditional routes where it may take a number of years for the funds invested in a company to be repaid, investments in an ICO become liquid immediately after a token is listed on an exchange. Faster liquidity is attractive to investors, so may increase the likelihood of investments being made in the ICO in the first place. The founders may consider this an indicator that they will be more likely to generate the funds they need.

However, there are also factors that would negatively affect the extent to which an ICO might be considered to be a suitable, acceptable and feasible approach to raising finance.

- **Funds received quickly, and up-front.** While the advantage of quickly raising capital was seen above, there are also risks involved. ICOs allow companies to raise money up front, and the amount they receive may be more than they actually need. This immediately will misalign the interests of the founders and the investors. When applying for finance through a traditional route, the start-up company would have to pass through multiple rounds and milestones. Each one would provide the investors with assurance over the competence of the team and their product. If this is bypassed, and the founders receive significant funds up front, there is no incentive for them to prove their worth to the investors. This is likely to lead to over-spending and as a result, the company may not perform as well as it could, potentially even leading to failure. This raises questions around the *suitability* of this source of finance.
- **No standards for white papers.** To launch an ICO, all a company needs to do is publish a 'white paper' with details of the concept that the tokens will be issued in exchange for cryptocurrency. Unlike the documents required in more formal financing routes, there are no standards governing what should be included in the white paper. This may mean important information is omitted, indicating that perhaps the company is not ready to launch its product. However, this would not be identified as it would in traditional financing routes, the ICO would go ahead and possibly the investors would lose their money and the venture would fail. ICOs are unlikely to be *suitable* for over-enthusiastic start-ups rushing into raising finance before they are ready.
- **Anonymity, and lack of transparency and oversight.** Anonymity and lack of transparency are inherent within blockchain technology and make ICOs a target for money

laundering and terrorist financing. The general lack of regulation and oversight of ICOs, and the variations in the approach to ICOs worldwide means that there is little comeback for investors when things go wrong. This may increase investors' reluctance to buy into to an ICO, thus making it less likely the finance will be raised and calling the *feasibility* of the ICO as a finance source into question.

- **Fraud and cybersecurity risk.** Ponzi schemes (fraudulent investing scams) involving virtual currencies have created nervousness among investors. If ICOs develop a poor reputation, their *acceptability* and *feasibility* as a source of finance are likely to be reduced. Cryptocurrencies are also susceptible to hackers and other cybersecurity issues.

When assessing whether or not an ICO is appropriate, the company will need to look at these factors alongside their strategy, objectives, operations and risk policies to inform the extent to which it would be considered a suitable, acceptable and feasible decision.

Written by a member of the Strategic Business Leader examining team

Chapter 23 Performance indicators

Executive Summary

Both Strategic Business Leader and Advanced Performance Management exams require candidates to be able to establish key performance indicators and critical success factors.

Introduction

Both Strategic Business Leader (SBL) and Advanced Performance Management (APM) require candidates to be able to establish key performance indicators and critical success factors. For example, Question 1 of December 2013 APM illustrates this.

A surprising number of candidates do not feel comfortable with these terms, and this article is aimed at explaining and illustrating these concepts. In particular it will explain what is meant by:

- Performance
- Objectives
- Critical success factors
- Performance indicators
- Key performance indicators.

Performance

This can be defined as:

‘A task or operation seen in terms of how successfully it is performed’
(www.oxforddictionaries.com).

Organisations differ greatly in which aspects of their behaviour and results constitute good performance. For example their aim could be to make profits, to increase the share price, to cure patients in a hospital, or to clear household rubbish. The concept of ‘performance’ is very relevant to both SBL and APM. SBL looks at how organisations can make decisions that improve their strategic performance and APM is focused on how organisations evaluate their performance.

The primary required tasks are often found in the organisation’s mission statement as it is there that the organisation’s purpose should be defined. These are called ‘primary required tasks’ because although the primary task of a profit-seeking business is to make profits, this rests on other subsidiary tasks such as good design, low cost per unit, quality, flexibility,

successful marketing and so on. Many of these are non-financial achievements.

Some aspects of performance are 'nice to have' but others will be critical success factors. For example, the standard of an airline's meals and entertainment systems will rank after punctuality, reliability and safety, all of which are likely to be critical to the airline's success.

Objectives

Objectives are simply targets that an organisation sets out to achieve. They are elements of the mission that have been quantified and are the basis for deciding appropriate performance measures and indicators. There is little point measuring something if you do not know whether the result is satisfactory and cannot decide if performance needs to change. Organisations will create a hierarchy of objectives which will include corporate objectives which affect the organisation as a whole and unit objectives which will affect individual business units within the organisation. Even here objectives will be categorised as primary and secondary, for example an organisation might set itself a primary objective of growth in profits but will then need to develop strategies to ensure this primary objective is achieved. This is where secondary objectives are needed, for example to improve product quality or to make more efficient use of resources.

Objectives often follow the SMART rule. They should be:

Specific: there is little point in setting an objective for a company to improve its inventory. What does that mean? It could mean that stock-outs should be less frequent, or average stock holdings should be lower, or the inventory will be held in better conditions to reduce wastage.

Measurable: if you can't measure something you will be at a loss as to how to control it. Some aspects of performance might be difficult to measure, but efforts must be made. Customer satisfaction is important to most businesses and indications could be obtained by arranging customer surveys, repeat business and so on.

Achievable/agreed/accepted: objectives are achieved by people and those people must accept and agree that the objectives are achievable and important.

Relevant: relevant to the organisation and the person to whom the objectives are given. It is important that people understand how achieving an objective will help organisational

success. If this connection isn't clear, employees will begin to feel that the objective is simply a cynical exercise of management power. The person to whom the objective is given must also feel that they can affect its achievement.

Time-limited: all objectives have to be achieved within a specified time period otherwise procrastination will rule.

Critical success factors

A critical success factor (CSF) can be defined as:

'An area where an organisation must perform well if it is to succeed.'

Alternatively, Johnson, Scholes & Whittington defined CSFs as:

'Those product features that are particularly valued by a group of customers, and, therefore, where the organisation must excel to outperform the competition.'

This definition is more complex than the first, but it is more useful because it makes the organisation look towards its customers (or users) and recognises that *their* opinion of excellence is more important and reliable than internally generated opinions. If an organisation doesn't deliver what its customers, clients, patients, citizens or students value, it is failing.

Performance indicators and key performance indicators

Performance indicators (or performance measures) are methods used to assess performance. For example:

In profit-seeking organisations:

- Profit
- Earnings per share
- Return on capital employed

In not-for-profit organisations:

- Exam grades (a school)
- Waiting times for hospital admission (a health service)
- Condition of roads (a local government highways department)

Particularly in profit-seeking organisations, the prime financial performance indicators allow performance to be measured but they say little about how that performance has been achieved. So, high profits will depend on a combination of good sales volumes, adequate prices and sufficiently low costs. If high profits can only be achieved by a satisfactory combination of volume, price and cost, then those factors should be measured also and will need to be compared to standards and budgets.

Similar effects are found in not-for-profit organisations. For example, in a school, a CSF might be that a pupil leaves with good standards of literacy. But that might depend on pupil-teacher ratios, pupils' attendance and the experience of the teachers. If these factors contribute to good performance, they need to be measured and monitored.

Just as CSFs are more important than other aspects of performance, not all performance indicators are created equal. The performance indicators that measure the most important aspects of performance are the **key performance indicators (KPIs)**. To a large extent, KPIs measure how well CSFs are achieved; other performance indicators measure how well other aspects of performance are achieved

There are a number of potential pitfalls in the design of performance indicators and measurement systems:

- **Not enough performance measures are set**

Often, directors and employees will be judged on the results of performance measures. It has been said that 'Whatever gets measured gets done' and employees will tend to concentrate on achieving the required performance where it is measured. The corollary is that 'Whatever doesn't get measured doesn't get done' and the danger is that employees will ignore areas of behaviour and performance which are not assessed.

- **Too many performance indicators**

This occurs especially where performance measures are not ranked by importance and none have been identified as KPIs. Performance indicators have to be measured, calculated and reported to

management, and discrepancies must be explained or excuses invented. Too many measures can divert time from more important tasks and there is a danger that employees concentrate on the easier but more trivial measures than on the more difficult but vital targets.

- **The wrong performance measures**

An example of this would be applying strict cost measures in an organisation where luxury products and services are sold (a differentiation strategy). This is likely to detract from the organisation's strategic success.

- **Too tight/too loose performance measures**

Performance indicators that are too difficult to attain can lead to a loss of employee motivation and promote dysfunctional behaviours such as gaming and the misrepresentation of data. Performance measures that are too loose can pull down performance. Benchmarking can help to avoid this. Internal benchmarking generally sets measures based on previous period's measures or set measures with respect to other branches or divisions. However these internal benchmarks can lead to complacency as many organisations have to compete with others and benchmarks should be aligned to competitors' performance.

- **'Hit and run' performance indicators**

This means that a performance indicator is set and then it is assumed that things will look after themselves. Performance indicators need a management framework they are to be at all effective.

Performance measures – a practical framework

Expanding on the last point, above, to establish a performance measurement system, something like the following is needed for each measure:

1. A meaningful title of the measure
2. What is its purpose and how does that purpose relate to strategic success?
3. What other performance measures might be affected by this one, how are they affected and how are conflicts to be resolved?
4. Who will be held responsible for it?
5. What is the source data, who is responsible for its supply, how is it measured and how is the measure calculated?
6. What investigations and explanations are required and who is responsible?
7. What target is set and how has that target been determined?
8. How often should the target be updated?

9. How often is the measure reported on?
 10. Reporting and action?

For example, consider a passenger train company called TTTE:

1. Title of performance measure Punctuality (the percentage of trains arriving at their destination on time)

2. Purpose of performance measure TTTE's strategic objective is to provide comfortable, reliable and punctual services to passengers. TTTE competes with other train companies, cars, buses and airlines. Punctuality is seen as a key competitive lever and therefore must be measured

3. Other performance measures affected Safety – safety checks and speed limits will take priority over punctuality
 Cleanliness – it might be necessary to occasionally reduce cleaning to keep to the timetable
 Energy consumption running a train faster than normal (though within speed limits) will cause higher fuel consumption but punctuality takes precedence

4. Who is held responsible? Operations director

5. Source data, measurement and The duty manager at each station is responsible for logging the arrivals time of each train. A five-minute margin is allowed ie a train is logged 'on time' if it is no later than 5 minutes after the advertised time. Beyond five minutes the actual time

calculation of the measure.

by which the train is late is logged. Results will be calculated in percentage bands: on time, up to 15 minutes late, >15–30 minutes late, >30 minutes – one hour late, >one hour late, and so on

6. Investigations and explanations

While logging late arrivals, station duty managers should also note the cause where possible. The operations director must collate this information using statistical analysis which highlights persistent problems such as particular times of the day, routes or days of the week

7. Target and how it is determined

The target is dictated by the railway timetable. The timetable should be reviewed twice a year to look for ways of reducing journey times to keep TTTE competitive with improvements in competing transport

8. Update of target

The banding and any tolerances will be updated annually

9. How often should the measure be reported

Weekly

10. Reporting and action

The operations director will report performance on a monthly basis to the board together with plans for service improvement

Use of performance indicators in the SBL and APM syllabi

Performance indicators are relevant to the following models and theories:

Mission statements: these define the important aspects of performance that sum up the purpose of the organisation. See the article 'Reports for performance management' (see 'Related links').

Stakeholder analysis: recognises that different stakeholders have different views on what constitutes good performance. Sometimes what stakeholders want is different to what the mission statement suggests as the purpose of the organisation. This can be a particular problem when the stakeholders are key-players.

Generic strategies: the main generic strategies to achieve competitive advantage are cost leadership and differentiation. If a company's success depends on being a cost leader (a CSF) then it must carefully monitor all its costs to achieve the leadership position. The company will therefore make use of performance indicators relating to cost and efficiency. If a company that has chosen differentiation as its path to success then it must ensure that it is offering enhanced products and services and must establish measures of these.

Value chain: a value chain sets out an organisation's activities and enquires as to how the organisation can make profits: where is value added? For example, value might be added by promising fantastic quality. If so, that would be a CSF and a key performance indicator would be the rate of occurrence of bad units.

Boston consulting group grid: this model uses relative market share and market growth to suggest what should be done with products or subsidiaries. In SBL if a company identifies a product as a 'problem child' BCG says that the appropriate action for the company is either to divest itself of that product or to invest to grow the product towards a 'star' position on the grid. This requires money to be spent on promotion, product enhancement, especially attractive pricing and perhaps investment in new, efficient equipment. In APM the model would be used to establish how to manage the performance of the products and what measures should be used depending on their position in the grid. For example, good performance for a star would be measured by market share growth rather than profits. Return on investment could be low until full use is made of the new

equipment. Once a product reaches its 'cash cow' stage performance measures will focus on revenues, costs and profits.

PESTEL and Porter's five forces: both the macro-environment and competitive environment change continuously. Organisations have to keep these under review and react to the changes so that performance is sustained or improved. For example, if laws were introduced which stated that suppliers should be paid within a maximum of 60 days, then a performance measure will be needed to encourage and monitor the attainment of this target.

Product life cycle: different performance measures are required at different stages of the life cycle. In the early days of a product's life, it is important to reach a successful growth trajectory and to stay ahead of would-be copycats. At the maturity stage, where there is great competition and the market is no longer growing, performance will depend on low costs per unit and maintaining market share to enjoy economies of scale.

Company structure: different structures inevitably affect both performance and its management. For example as businesses become larger many choose a divisionalised structure to allow specialisation in different parts of the business: manufacturing/selling, European market/Asian market/North American market, product type A/product type B. Divisional performance measures, such as return on investment and residual income, then become relevant.

Information technology (IT): new technologies will influence performance and could help to more effectively measure performance. However, remember that sophisticated new technology does not guarantee better performance as costs can easily outweigh benefits. If IT is vital to a business then downtime and query response time become relevant as might a measure of system usability.

Human resource management: what type of people should be recruited, and how are they to be motivated, appraised and rewarded to maximise the chance of good organisational performance? Performance measures are needed, for example, to monitor the effectiveness of training, job performance, job satisfaction, recruitment and retention. In addition, considerable effort has to be given to considering how employees' remuneration should be linked to performance.

Fitzgerald and Moon building blocks

Section E(1) of the APM *Study Guide* mentions three specific approaches or models:

- Balanced scorecard
- Performance pyramid
- Fitzgerald's and Moon's building blocks

The balanced scorecard approach is probably the best known but all seek to ensure that the net is thrown wide when designing performance measures for organisations so that factors such as quality, innovation, flexibility, stakeholder performance, and delivery and cycle time are listed as being important aspects of performance. Whenever an aspect of performance is important then a performance measure should be designed and used.

The Fitzgerald and Moon model is worth a specific mention here as it is the only model which explicitly links performance measures to the individuals responsible for the performance.

The model first sets out the dimensions (split into results and determinants) where key performance indicators should be established. You will see there is a mix of financial and non-financial, and both quantitative and qualitative:

- Results
- Financial performance
- Competitive performance
- Determinants
- Quality
- Flexibility
- Resource utilisation
- Innovation

The model then suggests **standards for KPIs**:

- Ownership: refers to the idea that KPIs will be taken more seriously if staff have a say in setting targets. Staff will be more committed and will better understand why that KPI is needed.
- Achievability: if KPIs are frequently and obviously not achievable then motivation is harmed. Why would staff put in extra effort to try to achieve a target (and bonus) if they believe failure is inevitable.
- Fairness: everyone should be set similarly challenging objectives and it is essential that allowance should be made for uncontrollable events. Managers should not be penalised for events that are

completely outside everyone's control (for example, a natural disaster) or which is someone else's fault.

The model then suggests how employee **rewards** should be set up to encourage employees to achieve the KPI targets:

- Clarity: exactly how does performance translate into a reward?
- Motivation: the reward must be both desirable and must be perceived as achievable if it is to be motivating.
- Controllable: achievement of the KPI giving rise to the reward should be something the manager can influence and control.

Adapted from an article originally written by Ken Garrett (a freelance lecturer and writer)